

TRADE BASED MONEY LAUNDERING: EXPLORING THE IMPLICATIONS FOR INTERNATIONAL BANKS

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Abstract

Written in response to a current gap in academic and industry based literature, this thesis was written on the topic of Trade Based Money Laundering (TBML) and risk assessment, within the banking context. Despite the increased use of TBML, most academic descriptions of money laundering have used the cash based model of placement and integration of large cash deposits acquired from criminal activity, which are then merged into legitimate pre-existing funds. However, there are a significant number of examples to show that cash transferred into goods and then shipped to other countries can be easier to move and less conspicuous or traceable than simple cash based deposits. One of the main challenges for detecting shipping based laundering techniques is that they involve a number of agencies sharing data and information, in order to catch the criminals. Simple banking checks may not always elicit the required information without verification from either customs or law enforcement agencies. The research sought to identify the current challenges and issues facing risk assessment professionals in the banking sector and to identify gaps in the current systems being used. The data collected included interviews and survey information taken from professionals working on AML risk assessment in banking and financial institutions from across the globe. In addition to the description of different money laundering schemes, much of the current academic discussion on money laundering in banking has focused on the regulation requirements for financial institutions to stop money laundering activity, but there has been little empirical guidance on how regulation can be adapted and implemented at the individual banking level. This research accessed a number of legal cases available in the public domain, which were analysed to see how and where some of the larger banks have failed to implement current anti-money laundering controls and to consider how this could impact on the detection of TBML activity. This research uses an Agency theory model to look at the pressures banks are under to manage client's accounts efficiently, versus the requirements of outside regulation to undertake extensive checks on business transactions and accounts. Finally, the researcher proposed a simple risk matrix approach that developed the current thinking of client behaviour and transaction monitoring risk analysis associated with cash based laundering, to develop a four-point risk model that added geography and third party behaviour, to account for shipping and trade based laundering activity.

Keywords: TBML, Trade Based Money Laundering, Banking AML risk assessment, Anti Money Laundering, Risk Assessment.

ABSTRACT.....	2
LIST OF TABLES	19
LIST OF FIGURES.....	20
ACKNOWLEDGEMENTS	21
ABBREVIATIONS.....	23
<i>CHAPTER 1 INTRODUCTION</i>	<i>25</i>
1.1 Introduction	26
1.1.1 Exploratory Study.....	30
1.1.1.1 Introductory Justification	31
1.2 Overview of TBML	32
1.2.1 Money Laundering and Its Sources.....	34
1.2.2 Impact of Technology on Global Money Laundering Activity.....	39
1.2.3 Trade Based Money Laundering (TBML).....	42
1.2.3.1 Financial Action Task Force	43
1.2.3.2 Suspicious Alerts	47
1.2.3.3 Comparative AML Approaches With a Focus on the United Kingdom	
54	
1.2.3.4 Proceeds of Crime Act (POCA)	54
1.2.3.5 POCA Case Law.....	55
1.2.3.6 POCA Analysis.....	56
1.2.3.7 POCA Amendments Since 2002	59
1.2.4 International Review.....	61
1.2.4.1 Spain Review	63
1.2.4.2 Malaysia Review.....	64

1.2.4.3	Australia Review.....	65
1.2.4.4	International Growth Phase.....	66
1.2.5	Sovereignty	67
1.2.5.1	Critical Challenges to AML Enforcement.....	68
1.2.5.2	FATF Challenges in Developing Countries.....	71
1.2.6	AML Regulation.....	73
1.3	Governance	77
1.3.1	Ethical Behaviour	78
1.3.1.1	Beyond the Ethics of Bank Employees	79
1.3.2	Evolving Risk.....	81
1.3.3	Internal Audit	82
1.3.4	Technology.....	85
1.4	Trade Based Money Laundering Research Project	87
1.4.1	Methodology	87
1.4.2	Justification for the Research	89
1.4.3	Research Problem.....	91
1.4.4	The Research Context	92
1.4.5	Delimitations of Scope and Key Assumptions	95
1.4.6	Conclusion.....	95
	CHAPTER 2 BACKGROUND ISSUES.....	97
2	INTRODUCTION.....	98
2.1.1	Trade Based Money Laundering (TBML).....	101
2.1.2	Normal Trading Practices.....	104
2.1.3	Using Trade Based Money Laundering	105

2.1.4	Banking Services and TBML	107
2.1.5	Hijacking Customer Accounts	107
2.1.6	Enterprise of Letters Of Credit.....	111
2.1.7	UCP 600 and Money Laundering	115
2.1.8	Over and Under Invoicing	116
2.1.9	Detecting Trade Anomalies.....	118
2.1.10	Criminal Behaviour	120
2.1.10.1	Corporate Fraud	120
2.1.10.2	False Identification	122
2.1.10.3	Straw Men	123
2.1.10.4	False Shipping Documents	124
2.1.10.5	United Kingdom’s Financial Conduct Authority on Training	125
2.2	Trade Based Money Laundering Detection.....	127
2.2.1	Banking and TBML	127
2.2.1.1	TBML Definition in Banking.....	129
2.2.2	Risk Assessment.....	130
2.2.2.1	TBML Risk Assessment	133
2.2.3	Detecting TBML activity	134
2.2.3.1	Current AML detection	136
2.2.3.2	Customer Due Diligence (CDD)	136
2.2.4	Beneficial Ownership Information (BOI).....	137
2.2.5	Multiple Banking Partners	139
2.3	Red Flags	143
2.3.1	TBML Patterns - Red Flag Alerts	145
2.3.2	Use of Data Technology in Risk Assessment.....	149

2.3.3	Use of Trade Data Technology.....	150
2.3.4	Trade Transparency Units.....	152
2.3.5	Challenges of Trade Data Comparisons.....	154
2.3.6	Implications for the Banking Sector.....	156
2.4	Internal Audit	157
2.4.1	Role of Internal Audit in AML	159
2.4.2	An Independent Role for the IAF	159
2.4.2.1	Assessing Effectiveness in IAF	161
2.4.2.2	Links to External Audit	161
2.4.2.3	IAF and AML Risk Assessment.....	163
2.4.2.4	Banking Implications	164
2.5	Internal Audit and Financial Intelligence Analysis	166
2.5.1	AML Compliance	170
2.5.2	Internal Audit and Risk Assessment.....	171
2.6	Conclusion	173
2.6.1	Empirical Implications.....	175
2.6.2	Key Findings	178
2.6.3	Risk Based system	178
2.6.4	Banking Definition and Focus for TBML detection	179
2.6.5	Implication for the Governance of Banks	180
CHAPTER 3 ACADEMIC BACKGROUND		182
3.1	Introduction	183
3.1.1	Systematic Review	184
3.2	Literature Methodology	187
3.2.1	Scope of the review	188

3.2.2	Literature Search.....	189
3.2.3	Crime.....	189
3.2.3.1	Criminal Motivation	190
3.2.3.2	Money Laundering / TBML regulation	190
3.2.4	Banking Regulatory Response.....	190
3.2.4.1	Intelligence Data	191
3.2.5	Risk Assessment & AML Compliance	191
3.3	CRIMINAL MOTIVATION.....	194
3.3.1	Client Behaviour - Money Launderer Behaviour	194
3.3.2	Criminal Motivation Theories	196
3.3.3	Criminals	199
3.3.4	Socio-economic Risk	201
3.3.5	Bribery and Corruption	202
3.3.6	Professional Launderers	204
3.4	Money Laundering & International Regulation	205
3.4.1	Global Economic Implications of AML	206
3.4.2	A Theoretical Perspective on Regulation.....	208
3.4.3	Regulators	211
3.4.4	International Regulatory Context	212
3.4.5	Global Banking Regulation.....	213
3.5	Banking Regulation & Responses.....	215
3.5.1	Regulation and Information Gathering.....	216
3.5.2	Assessing Financial Intelligence Data.....	218
3.5.3	Bank Responses to Regulation.....	219
3.6	Risk Assessment	223

3.6.1	Systemic AML Risk	224
3.6.2	HSBC Bank in the United States of America (HBUS)	227
3.6.2.1	HBUS Investigation.....	228
3.6.3	Affiliate Banks	229
3.6.4	High Risk Countries	231
3.6.5	Bulk Travellers' Cheques.....	233
3.6.6	Bearer Share Accounts.....	233
3.6.7	Suspicious Alerts	234
3.6.8	Risk Assessment.....	234
3.6.9	OCC	235
3.6.10	Governance Implications.....	238
3.6.11	HSBC in the US.....	239
3.6.12	HSBC Switzerland.....	240
CHAPTER 4 METHODOLOGY.....		246
4.1	Introduction	247
4.2	Research problem	248
4.2.1	Research Framework - Overview	250
4.3	Philosophical Stance.....	252
4.3.1	Ontological Position.....	252
4.3.2	Global Money Transfer	253
4.3.3	Risk Based Approach.....	254
4.3.4	Vulnerabilities and Entry Points into the Financial Sector.....	255
4.3.5	Epistemological Position	256
4.3.6	Dual Agency Role	257
4.3.7	Application to Risk Assessment	257

4.4	Research - Theoretical Framework	259
4.4.1	Framework.....	260
4.5	Agency Theory.....	262
4.5.1	TBML & Agency Theory.....	263
4.5.2	Agency Theory & Other Theoretical Frameworks	265
4.5.3	Multi-theoretical Frameworks.....	267
4.5.4	Multi-theoretical Approach	267
4.6	Research context.....	268
4.6.1	Research Paradigms.....	269
4.6.1.1	Traditional Paradigms	271
4.6.2	Level 1 - Research Philosophy for TBML Project	272
4.6.2.1	Research Philosophy	272
4.6.2.2	Positivism	273
4.6.2.3	Interpretivism.....	273
4.6.2.4	Critical realism.....	277
4.6.3	Level 2 - Research Approach.....	279
4.6.3.1	Delphi Analysis	280
4.6.3.2	E-Delphi	282
4.6.3.3	Expert Panels.....	283
4.6.3.4	Expert Panel	286
4.6.4	Level 3 - Research Strategy.....	289
4.6.4.1	Challenges for the research strategy to address	290
4.6.4.2	Empirical Challenges	291
4.6.4.3	Multi-disciplinary	293
4.6.4.4	Theoretical framework.....	293

4.6.4.5	Grounded Strategy	294
4.6.5	Research Choices	296
4.6.5.1	Exploratory Research	297
4.6.5.2	Mixed Methods	301
4.6.5.3	Primary Data	304
4.6.5.4	Secondary Data	304
4.6.5.5	Mixed Methods	305
4.6.5.6	Triangulation with Mixed Methods Designs	307
4.6.5.6.1	Method triangulation.....	311
4.6.5.6.2	Theoretical triangulation	311
4.6.5.7	Validity within the research design.....	312
4.6.5.7.1	External validity or Transferability	313
4.6.5.7.2	Internal Validity or Credibility	314
4.6.5.7.3	Construct Validity.....	314
4.6.5.8	Limitations.....	316
4.6.5.8.1	Number of Experts.....	316
4.6.5.8.2	Internal Audit.....	317
4.6.5.8.3	Online Engagement.....	318
4.6.5.8.4	Access to Banking Officials.....	319
4.6.5.8.5	Trade Data and links to Customs Officials.....	319
4.7	ETHICAL CONSIDERATIONS	321
4.7.1	Voluntary Informed Consent	323
4.7.2	Confidentiality.....	324
4.7.3	Anonymity.....	325
4.7.4	Right to Withdraw.....	326
4.7.5	Detriment Arising From Participation in the Research.....	327
4.7.6	Feedback to Participants	327

4.7.7	Dual Role of Practitioner and Researcher.....	328
4.7.8	Personal Safety	329
4.7.9	Challenges in research ethics.....	329
4.7.10	Timeline	330
4.7.10.1	Ten Year Time Scale	330
4.7.11	Historical Cases.....	331
4.7.12	Techniques and Procedures	332
4.7.12.1	Data Collection Methods	333
4.7.12.2	Broad Information Outcomes	333
4.7.12.3	In-depth Information outcomes	334
4.7.12.4	Technology	335
4.7.13	Sampling technique	336
4.7.13.1	Broad level sample	337
4.7.13.2	In-depth level sample.....	340
4.7.13.3	On-line Survey	341
4.7.13.3.1	Reasons for Using an Online Survey	344
4.7.13.4	Semi-Structured Interviews	345
4.7.13.4.1	Telephone and email interviews.....	346
4.7.13.4.2	Participants	347
4.7.13.4.3	Case Studies	347
4.7.13.4.4	Time Management.....	348
4.7.13.5	Secondary Data Collection	349
4.7.13.5.1	Typology Reports & Case Studies.....	350
4.7.13.5.2	Bank Case Studies	352
4.7.13.5.3	Industry Based Studies.....	353
4.8	Conclusion Methodology	354

4.8.1	Diversity within the research responses.....	356
4.8.2	Delphi.....	356
4.8.3	Ethics.....	357
4.8.4	Risk & Safety Assessment	358
4.9	Participants - Voluntary Informed Consent	359
4.9.1	Implications for Participants Workload	361
4.9.2	Participants Right to Withdraw	361
4.9.2.1	Follow Up On Participants Who Withdraw	362
4.9.3	Detriment to Participants	363
4.9.3.1	Avoiding disadvantage to any particular group of participants...	363
4.9.4	Privacy.....	364
4.9.5	Feedback to Participants	364
4.9.6	Avoiding Researcher Bias.....	365
CHAPTER 5 DATA ANALYSIS		366
5.1	Introduction	367
5.2	Data collection tools.....	367
5.2.1	Research Questions	368
5.3	TBML Complexity	371
5.3.1	Data Analysis Framework	372
5.4	TBML Typology Framework.....	376
5.4.1	Coding the Data	377
5.4.2	Qualitative Data Analysis	379
5.4.3	TBML Research Coding	380
5.4.4	DATA RESULTS	381
5.5	Financial Services Survey.....	382

5.5.1	Background of AML Respondents.....	383
5.5.1.1	Countries Represented In the Research.	383
5.5.2	Sector	385
5.5.3	Percentage of Time Spent On AML.....	387
5.5.4	TBML Risk Assessment.....	389
5.5.4.1	Methods Used To Detect TBML Activity	390
5.5.4.2	Main Person Responsible For Detecting TBML.....	391
5.5.5	Risk Assessment.....	392
5.5.6	Internal Audit.....	395
5.5.7	Improving TBML Detection	398
5.5.7.1	Impediments To TBML Detection	399
5.5.8	Governance.....	400
5.5.9	Suggestions for Moving Forwards On TBML Detection And Compliance....	403
5.5.10	Concluding Observations on the Survey	407
5.6	Interview Analysis	408
5.6.1	Thematic analysis of the Interviews	411
5.6.2	Risk Assessment Model	415
5.6.2.1	Risk Avoidance versus Risk Aversion.....	416
5.6.2.2	Developing Risk Management Expertise.....	417
5.6.2.3	Understanding Trade Specific Risks	419
5.6.2.4	Standardised Operations	420
5.6.2.5	Know Your Customer	420
5.6.2.6	Beneficial Ownership	420
5.6.2.7	Risk Assessment Tools.....	421
5.6.2.8	Weaknesses in TBML Risk Assessment	423

5.6.2.9	Risk Matrices	424
5.6.2.10	Knowledge Gap	424
5.6.2.11	Geographical Risk.....	425
5.6.2.12	A Step Too Far	426
5.6.2.13	Understanding Financial Crime	427
5.6.2.14	Cost of TBML Risk Assessment.....	428
5.6.2.15	Specific TBML reporting officer.....	428
5.6.2.16	Technology and Risk Assessment.....	429
5.6.2.17	Digital Document Formats	431
5.6.2.18	Linking to Current AML Software programmes	431
5.6.2.19	Managing Trade Data.....	432
5.6.2.20	Using Technology to Manage External Risks.....	433
5.6.2.21	TBML Data Management	433
5.7	Internal Audit	436
5.7.1	Role of Internal Audit.....	436
5.7.1.1	Separate Role - independent as 3 rd line of defence.....	439
5.7.2	Internal Auditing of AML.....	440
5.7.2.1	Risk Auditing.....	441
5.7.3	Lack of TBML Expertise	443
5.7.3.1	Summary Internal Audit	446
5.7.4	Internal Audit and Governance	446
5.7.5	Management.....	448
5.7.6	Culture of the Bank.....	449
5.7.7	Guidance and Resource Material / Regulators.....	450
5.7.8	External Audit	451

5.7.9	Corporate Responsibility.....	451
5.7.10	Resources	452
5.8	Training TBML	454
5.8.1	Use of External Training Agencies	454
5.8.2	Training Approach.....	457
5.8.3	Topics to be Covered	459
5.8.4	Guidelines	460
5.8.5	Investigative Skills	461
5.8.6	Future Priorities	461
5.8.7	Secondary Data Reports	463
5.8.8	PWC Report (2014): Internal audit holding the line on BSA/AML compliance	464
5.8.9	Commentary on the Report.....	466
5.8.10	Financial Conduct Authority	467
5.8.11	Commentary on the Report	470
5.8.12	HBUS Risk Assessment Profile	471
5.8.13	HSBC Switzerland Risk Assessment Profile.....	473
5.8.14	Conclusion Secondary Data	473
CHAPTER 6 FINDINGS		475
6.1	Introduction	476
6.2	Research Questions.....	477
6.2.1	Weaknesses in Risk Assessment Models	482
6.2.2	Information That the Client Needs To Know	482
6.2.3	Front and legitimate companies.....	484
6.2.4	Geographical Risks	485
6.2.5	Trade Patterns	485

6.2.6	Technology.....	486
6.2.7	Training and Resources.....	488
6.2.8	TBML Auditing.....	489
6.3	Risk Assessment Framework.....	492
6.3.1	Tier One - Resources and Governance	493
6.3.1.1	Resources and training.....	493
6.3.1.2	Governance	494
6.3.2	Tier Two - Risk Assessment Matrix	496
6.3.2.1	Geographical Risk.....	498
6.3.2.2	Client Behavioural Risk.....	499
6.3.2.3	Client Transaction Risk	501
6.3.2.4	Third Party Risk	502
6.3.2.5	Risk Matrix.....	505
6.3.2.6	Reasons for Developing a More Complex Risk Assessment Process	508
6.3.3	Tier Three - Research and Technology	510
6.3.3.1	Research Sources	510
6.3.3.2	Advantages of the Revised Risk Matrix Model	512
6.4	Comparing the Risk Assessment Matrix to Industry Reports.....	514
6.4.1	AUSTRAC Typology Reports	514
6.4.2	Geographical/ International Funds	516
6.4.3	Client.....	517
6.4.4	Transaction	517
6.4.5	Business Partners / Third Party involvement	519
6.5	AML Risk Auditing	521
6.5.1	Internal Audit.....	522

6.5.2	The role of audit within AML compliance.....	523
6.5.3	AML Auditing (and TBML).....	523
6.5.4	Internal Audit or AML Audit.....	526
6.5.5	Difference between AML Compliance and AML Audit	527
6.5.6	Data Technology	528
6.6	Layer Defence Model	528
6.6.1	A New Model of Risk Assessment.....	531
6.6.2	National Quality Standards.....	533
CHAPTER 7 CONCLUSION.....		535
7.1	Introduction	536
7.2	An AML Risk Assessment Strategy	537
7.3	Theoretical Framework.....	538
7.3.1	Influences on the Agent - Corporate Attitude	542
7.3.2	Implications Arising From the Theoretical Discussions	543
7.3.3	Broader Application of Theoretical Analysis.....	544
7.3.4	Summary of Theoretical Analysis.....	547
7.4	Research Proposals	548
7.4.1	New Empirical Risk Assessment Framework	550
7.4.2	Four Areas of Risk (as opposed to the traditional two).....	550
7.4.3	Implications of Needing TBML Knowledge	552
7.4.4	Governance and AML Risk Assessment	553
7.4.5	A New Layer of Defence Model for Risk Assessment	553
7.4.6	AML Audit	554
7.5	Empirical Research Material	555
7.6	Concluding statement	558

7.6.1	Reflective Statement	559
-------	----------------------------	-----

<i>BIBLIOGRAPHY</i>	563
----------------------------------	------------

List of Tables

TABLE 1: U.S. EXPORTS AT LOW AVERAGES PRICES	153
TABLE 2: SAMPLE CODING PAPER	185
TABLE 3: SUB-DIVISION OF DIFFERENT LITERATURE SOURCES (THE LITERATURE HAS BEEN SUB CATEGORISED INTO FOUR KEY AREAS. THE BROADER BACKGROUND AREA OF FINANCIAL CRIME LINKING INTO MONEY LAUNDERING SPECIFICALLY AND THEN THE FOCUS OF THIS RESEARCH, WHICH IS TRADE BASED MONEY LAUNDERING.).....	193
TABLE 3: SUMMARY OF RESEARCH QUESTIONS AND PRIMARY AND SECONDARY DATA SOURCES	375
TABLE 4: SUMMARY OF SUGGESTIONS DIRECTED TOWARDS IMPROVING TBML COMPLIANCE.	403
TABLE 4: RISK ASSESSMENT	506

List of Figures

FIGURE 1 - EXAMPLE OF SMURFING ACTIVITY REPRODUCED FROM AUSTRAC (2014, P77)149

FIGURE 2: AML RISK MODEL 197

FIGURE 3—TBML RESEARCH MODEL - ADAPTATION OF THE ONION MODEL..... 251

FIGURE 4: ROLE OF IA..... 438

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Abbreviations

The research topic uses several different abbreviations, the most commonly used ones are listed below.

ABC – Anti Bribery and Corruption

AML - Anti-Money Laundering

APG - Asia Pacific Group

BOI - Beneficial Ownership Information

CDD - Customer Due Diligence

CFT - Countering the Financing of Terrorism

EDD - Enhanced Due Diligence

FATF - Financial Action Task Force

KYC - Know Your Customer

IAF - Internal Audit

IAF - Internal Audit Function

ML - Money Laundering

MLRO - Money Laundering Reporting Officer

TBML - Trade-Based Money Laundering

WB - World Bank

CHAPTER 1 INTRODUCTION

1.1 Introduction

This research project aims to explore the topic of Trade-Based Money Laundering as an emerging risk area, and to consider the implications for developing a risk assessment model. Interest in this topic arose after undertaking preliminary reading in money laundering and financial crime risks across the globe. It was discovered that most of the current reading still appeared to focus on cash based laundering schemes and older traditional models of moving drug money through the banking sector. However, many publications¹ mentioned the development of a newer and more complex laundering scheme that could move money

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FCA. (2013). Bank's control of financial crime risks in trade finance. London: Financial Conduct Authority.

de Boyrie, M. E., Nelson, J. A., & Pak, S. J. (2007). Capital movement through trade misinvoicing: The case of Africa. *Journal of Financial Crime*, 14(4), 474-489. doi:10.1108/1359079071082818.

Keene, S. D. (2011). Emerging threats: Financial crime in the virtual world. *J of Money Laundering Control*, 15(1), 25-37. doi:10.1108/1368520121119471.

internationally using the shipping sector. Works such as Sullivan and Smith's² review of TBML risks and regulatory responses highlighted how this newer technique worked, whilst examples from the APG report³ showed the reality of how current TBML techniques operated in the Asia Pacific region. Despite these initial publications there appeared to be very little other research material dedicated specifically to examining how TBML activity could be detected within the banking sector. This research project aimed to address the dearth of material available by providing an in-depth review of all the current TBML material and speaking to the major players within the AML sector that might have inside knowledge and experience in TBML crimes.

The research study focuses specifically on banking risk assessment and detection, since researchers have acknowledged that risk assessment is difficult given the complex nature of the methods used in TBML crimes. In particular, the research examines the role of other internal monitoring mechanisms within the bank such as internal audit and front office staff and considers the options for strengthening AML compliance through these existing systems.

In order to offer a relevant risk assessment, model the research aims to explore and understand the different components of the financial crime of 'Trade-based Money Laundering' ("TBML"), and to provide greater

²Sullivan, C., & Smith, E. (2011). Trade based money laundering- risks and regulatory responses. Australia: Australian Institute of Criminology. Retrieved from http://aic.gov.au/media_library/publications/rpp/rpp115.pdf

³ APG Typology Report on Trade Based Money Laundering. (2012) Sydney: Asia Pacific Group on Money Laundering.

insight into how this crime can be detected. This is considered to be particularly important to the researcher due to the limited coverage of TBML currently available in academic research.⁴ This is coupled with the empirical challenges that banks are faced with trying to understand how risk assessment approaches can be developed or enhanced to support TBML detection.⁵ This is seen as an important and relevant topic to the industry given the increasing proliferation of financial crime across the globe and the heightened media coverage of recent TBML and money laundering schemes linked to the banking sector.⁶

The term TBML in this research context is defined as the movement of illicit funds through trade finance options and which uses access to the main financial services for the purposes of laundering. This is opposed to other forms of trade deceit activities such as tax evasion which may use similar techniques to TBML. Unlike some forms of financial crime where the crimes may start with money already in the banking system, the starting process for the financial trail with TBML usually occurs outside of

⁴ Soudijn, M. (2014). A Critical Approach to Trade-Based Money Laundering. *Journal of Money Laundering Control* Vol 17, Iss 2, 230-242.

Kumanayake, N.S., 2015. TRADE-BASED MONEY LAUNDERING: AN OBSTACLE TO TRADE FACILITATION. First published 16 April 2013 (License for publishing–KB № 19433–9233P from 2012-09-21, Ukrainian Academy of Customs) The Customs Scientific Journal CUSTOMS is published twice a year. The website is at: www.ccjournals.eu/ojs/index.php/customs © 2015 Regional Office for Capacity Building & Regional Training Centers for the European Region, p.47.

Naheem, M.A., 2015. Trade based money laundering: towards a working definition for the banking sector. *Journal of Money Laundering Control*, 18(4), pp.513-524.

Sullivan, C., & Smith, E. (2011). Trade based money laundering- risks and regulatory responses. Australia: Australian Institute of Criminology. Retrieved from http://aic.gov.au/media_library/publications/rpp/rpp115.pdf

Keesoony, S. and Keesoony, S., 2016. International anti-money laundering laws: the problems with enforcement. *Journal of Money Laundering Control*, 19(2), pp.130-147.

Durrieu, R., 2013. Rethinking money laundering & financing of terrorism in international law: towards a new global legal order. Martinus Nijhoff Publishers.

⁵ FATF. (2008). Trade based money laundering. France. Financial Action Task Force

⁶ ICIJ (2015) Swiss leaks: Murky cash sheltered by bank secrecy <http://www.icij.org/project/swiss-leaks/banking-giant-hsbc-sheltered-murky-cash-linked-dictators-and-arms-dealers>

the banking sector.⁷ It is only after the actual criminal activity has occurred and the criminal has acquired money, which they wish to use for legitimate purposes, that the financial services sector becomes involved. Traditional models of money laundering have centred around a model of placing, layering and integrating money ⁸ before it is clean and available for legitimate transactions. However, this research will examine whether that model is applicable in the context of TBML activity, which also includes other financial and business services, in order to move and disguise the source of the funds.

⁷ Durrieu, R. (2013). *Rethinking money laundering & financing of terrorism in international law*. Boston: Martinus Nijhoff.

⁸ McDowell, J., & Novis, G. (2001). The Consequences of Money Laundering and Financial Crime. *Economic Perspectives*, An Electronic Journal of the U.S. Department of State, 6(2), 3-.

1.1.1 Exploratory Study

Most academic studies set out to prove a testable theory; a hypothesis is what the researcher anticipates the result will be, and is typically formulated in the introduction. He or she postulates a hypothesis, a speculative answer to the question, “what is the expected outcome of the study?”.⁹ Many researchers, when composing their thesis, do not even consider themselves to be “testing a theory”.¹⁰ Yet there are many studies that do not pose a hypothesis. These are either exploratory or interpretative in nature.¹¹ The design of a hypothesis for this research study was not undertaken, because it is an exploratory piece¹² of research and not a quantitative research topic - therefore the chapters explaining the research aims and objectives cover this in greater detail.

⁹ Anon, ‘An Introduction to Research’, 2008, https://www.soas.ac.uk/cedep-demos/000_P506_RM_3736-Demo/unit1/page_25.htm

¹⁰ Kothari, C.R., 2004. Research methodology: Methods and techniques. New Age International.

¹¹ An exploratory study is defined as a study in an area where the basis of knowledge is so low that it is not possible to make a meaningful hypothesis. An example of exploratory research could be: Will mobile sharing apps affect economic development in Africa?

There are simply not enough people using these applications across the continent to make meaningful predictions, or gather statistically relevant results. However, e-commerce businesses are still invested in understanding what the impacts could be, and what barriers could exist to the spread and uptake of the applications. Exploratory research is therefore based more on information gathering such as questionnaires and focus groups, as well as literature reviews, than testing a specific theory. Exploratory research theses may not require hypotheses, but they are nonetheless required to state clearly the study’s research objectives and methods.

An interpretative study is the second type of study that does not require a hypothesis. These studies seek to build knowledge by understanding meaning. The essential goal of the study is usually to understand how others attach meaning to events and experiences. Interpretative studies feature comparatively often in the educational or pedagogic sciences. Interpretative studies draw data from a variety of sources such as interviews and observations, and interpret the data according to prevailing theoretical models. The researcher is usually the primary interpreter of the observations, and categorizes the data into patterns or themes, which are then interpreted through the researcher’s own disciplinary lens. An example of an interpretive study would be: How are 9th grade students at Columbia High School responding to the new interactive instructional techniques?

Interpretative studies of this kind should, in lieu of a hypothesis, clearly state their methodology, nature of their sample groups, context, background and objectives as well as any theoretical paradigms the researcher will apply to their observations.

¹² Grove, W.M. and Andreasen, N.C., 1982. Simultaneous tests of many hypotheses in exploratory research. *The Journal of nervous and mental disease*, 170(1), pp.3-8.

1.1.1.1 Introductory Justification

The underlying context for the research is the belief that trade based money laundering is a complex issue that affects all banks involved in international financial transfers. The AML response from banks requires a number of monitoring and regulatory approaches to be adopted, if they are to remain non-complicit in supporting this type of criminal activity. These typically include collecting data on customer and client business transactions however many countries¹³ have weak AML systems¹⁴ and

¹³ The Basel Institute on Governance in its 2016 Basel Anti-Money Laundering Index, (an annual ranking assessing 149 countries - the only research-based risk rating of countries in this field by an independent non-profit institution) stated that "The top 10 countries of highest risk are Afghanistan, Cambodia, Guinea-Bissau, Iran, Mali, Mozambique, Myanmar, Swaziland Tajikistan, Uganda." ("Fighting money laundering remains weak in most countries according to Basel AML Index 2016". (2016) Basel Institute of Governance, Basel, Switzerland. Available at : https://index.baselgovernance.org/sites/index/documents/Basel%20AML%20Index%202016_Media%20Release.pdf)

The 2013 publication Money Laundering and Financial Crimes Country Database commissioned by the United States Department of State Bureau for International Narcotics and Law Enforcement Affairs grouped countries into three categories:

1. Jurisdictions of Primary Concern.
2. Jurisdictions of Concern.
3. Other Countries/Jurisdictions Monitored.

"Jurisdictions of Primary Concern" are those identified, pursuant to INCSR reporting requirements, as "major money laundering countries." A major money laundering country is defined by statute as one "whose financial institutions engage in currency transactions involving significant amounts of proceeds from international narcotics trafficking." However, the complex nature of money laundering transactions today makes it difficult in many cases to distinguish the proceeds of narcotics trafficking from the proceeds of other serious crime. Moreover, financial institutions engaged in transactions that involve significant amounts of proceeds from other serious crimes are vulnerable to narcotics-related money laundering. The category "Jurisdiction of Primary Concern" recognizes this relationship by including all countries and other jurisdictions whose financial institutions engage in transactions involving significant amounts of proceeds from all serious crimes or are particularly vulnerable to such activity because of weak or non-existent supervisory or enforcement regimes or weak political will. Thus, the focus in considering whether a country or jurisdiction should be included in this category is on the significance of the amount of proceeds laundered, not of the anti-money laundering measures taken. This is a different approach taken than that of the Financial Action Task Force's International Cooperation Review Group exercise, which focuses on a jurisdiction's compliance with stated criteria regarding its legal and regulatory framework, international cooperation, and resource allocations." Countries/Jurisdictions of Primary Concern: Afghanistan, Antigua and Barbuda, Argentina, Australia, Austria, Bahamas, Belize, Bolivia, Brazil, British Virgin Islands, Burma, Cambodia, Canada, Cayman Islands, China People Rep, Colombia, Costa Rica, Curacao, Cyprus, Dominican Republic, France, Germany, Greece, Guatemala, Guernsey, Guinea Bissau, Haiti, Hong Kong, India, Indonesia, Iran, Iraq, Isle of Man, Israel, Italy, Japan, Jersey, Kenya, Latvia, Lebanon, Liechtenstein, Luxembourg, Macau, Mexico, Netherlands, Nigeria, Pakistan, Panama, Paraguay, Philippines, Russia, Singapore, Somalia, Spain, St. Maarten, Switzerland, Taiwan, Thailand, Turkey, Ukraine, United Arab Emirates, United Kingdom, United States, Uruguay, Venezuela, and Zimbabwe. Reference: (2013 Vol. II country database of "Money Laundering and Financial Crimes Country Database". (2013). United States Department of State Bureau for International Narcotics and Law Enforcement Affairs. <https://www.state.gov/documents/organization/211396.pdf>)

information such as client details and beneficial ownership are often missing.¹⁵ Therefore, part of the aim for this research is to establish what kind of information is required to support an effective TBML risk assessment framework.

1.2 Overview of TBML

The focus of this research is on the detection and tracking of money acquired through illicit activity. As this money enters into the financial services industry it is detected through the implementation of anti-money laundering (AML) regulation. However, many banks have struggled to develop effective AML responses and there have been a number of legal cases,¹⁶ especially in the US, where large banks have been fined for

¹⁴The FATF statement of 19 February 2016 stated "As part of its on-going review of compliance with the AML/CFT standards, the FATF has to date identified the following jurisdictions which have strategic AML/CFT deficiencies for which they have developed an action plan with the FATF. While the situations differ among each jurisdiction, each jurisdiction has provided a written high-level political commitment to address the identified deficiencies. The FATF welcomes these commitments. A large number of jurisdictions have not yet been reviewed by the FATF. The FATF continues to identify additional jurisdictions, on an on-going basis, that pose a risk to the international financial system." Jurisdictions with strategic deficiencies: Afghanistan, Bosnia and Herzegovina, Guyana, Iraq, Lao PDR, Myanmar, Papua New Guinea, Syria, Uganda, Vanuatu, and Yemen. ("Improving Global AML/CFT Compliance: on-going process – 19 February 2016". (2016). FATF, Paris, France Available at www.fatf-gafi.org/publications/high-riskandnon-cooperativejurisdictions/documents/fatf-compliance-february-2016.html)

¹⁵ OECD. (2014). Illicit financial flows from developing countries: Measuring OECD responses. France: OECD

¹⁶ Money Laundering Bulletin. (2016) "Cases" Money Laundering Bulletin, Informa UK Limited. Available at: www.moneylaunderingbulletin.com/legalandregulatory/cases/

Thompson Jennifer. (2016). "Ulster Bank fined €3.3m by Irish central bank" The Financial Times Ltd. Available at: <https://www.ft.com/content/a95c6ad4-85c4-3fb7-872b-ad70b38415ea>

FCA. (2017) "FCA fines Deutsche Bank £163 million for serious anti-money laundering controls failings." The Financial Conduct Authority (FCA) UK. Available at: <https://www.fca.org.uk/news/press-releases/fca-fines-deutsche-bank-163-million-anti-money-laundering-controls-failure>

AML ABC. (2016). "100+ AML fines on historical timeline scale" AML ABC. Available at: <https://amlabc.com/aml-timelines-on-historical-scale/>

Kitten, Tracy. (2014) "JPMorgan Chase Fines Exceed \$2 Billion" Information Security Media Group, Corp. Available at: www.bankinfosecurity.com/chase-a-6356

FCA. (2016). "FCA imposes penalties on Sonali Bank (UK) Limited and its former money laundering reporting officer for serious anti-money laundering systems failings." The Financial Conduct Authority (FCA) UK. Available at: <https://www.fca.org.uk/news/press-releases/fca-imposes-penalties-sonali-bank-uk-limited-money-laundering>

failing to implement the regulations¹⁷ such as HSBC.¹⁸ As a result, money laundering (ML) has become a key area of focus for risk assessment within the global banking sector¹⁹ particularly within AML units but also for management and corporate governance structures. Part of the increased focus may also be that in addition to the legal cases, the media and the public's attention has also been focused on watching how banks are responding to this issue. Within the banking context the impact of weak AML controls and increased fines has also brought into question the role of governance and internal audit²⁰ in protecting the bank from the risk that ML poses. These risks include both the reputation of the bank amongst stakeholders as well as the social and economic damage that ML can cause if it remains undetected.²¹

A key element of this research project is to understand how the capacity of banks can be further developed to undertake TBML risk assessment. This includes increasing corporate governance involvement

DailyBriefing. (2016) "Italian bank Intesa Sanpaolo fined £189m for breaching US anti-money-laundering rules" Available at: biz.newsbelow.com/daily-briefing-italian-bank-intesa-sanpaolo-fined-189m-for-breaching-us-anti-money-laundering-rules-22294/

Freifeld, Karen. (2017) 'Deutsche Bank fined for \$10 billion sham Russian trades'. Thomson Reuters. Available at: www.reuters.com/article/us-deutsche-mirrortrade-probe-idUSKBN15F1GT

Mexian, Lee. (2016) "StanChart and Coutts fined by MAS for anti-money laundering breaches" SPH DIGITAL NEWS. Available at: www.businesstimes.com.sg/government-economy/stanchart-and-coutts-fined-by-mas-for-anti-money-laundering-breaches

¹⁷ McCarthy, K. J., van Santen, P., & Fiedler, I. (2014). Modelling the money launderer: Micro theoretical arguments on anti-money laundering policy. *International Review of Law and Economics*. doi: 10.1016/j.irl.2014.04.00

¹⁸ Homeland Security. (2012). HSBC exposed US financial system to money laundering, drug, terrorist financing risks. From permanent sub committee on investigations. US Senate. Retrieved from <http://www.hsgac.senate.gov/subcommittees/investigations/media/hsbc-exposed-us-financial-system-to-money-laundering-drug-terrorist-financing-risks>

¹⁹ Demetis, D. S., & Angell, I. O. (2007). The risk-based approach to AML: Representation, paradox, and the 3rd directive. *J of Money Laundering Control*, 10(4), 412-428. doi:10.1108/136852007108309

²⁰ Altamuro, J., & Beatty, A. (2010). How does internal control regulation affect financial reporting? *Journal of Accounting and Economics*, 49(1-2), 58-74

²¹ Arnone, M & Borlini, L. (2010) "International Anti-Money Laundering Programs." *J of Money Laundering Control* 13, no. 3: doi:10.1108/13685201011057136

and also developing systems for the inclusion of internal audit, in relation to AML reporting and compliance. The systems that are developed for TBML detection also need to work alongside or enhance current AML systems for other money laundering techniques.

1.2.1 Money Laundering and Its Sources.

Money laundering has remained a vital component of criminal transactions since it was first devised. Although its origins are officially unknown, some authors have pointed to early Chinese traders hiding profits from rulers as an example of early money laundering activity this has dated as far back as 2000BC.²² Nowadays many of the criminal activities including piracy,²³ drug and human trafficking, illegal arms smuggling and organised criminal gangs, produce or generate illegally acquired money, which cannot be used in the mainstream economy until it has been laundered.²⁴ The biggest market for illicit cash is from drugs, which account for approximately 20% of all crime proceeds²⁵ and represents the equivalent to 0.6% of global GDP, with the cocaine market alone estimated to be worth \$88 billion according to UN sources²⁶ which is an increase from the more conservative estimate in 2009 from the

²² Morris-Cotterill (2002) A Brief History of Money Laundering

<http://www.countermoneylaundering.com/public/content/brief-history-money-laundering>

²³ Do, Q. -T., Blanc, J., Kruse, A., Le, T., Levchenko, A., Ma, L., Shortland, A. (2013). The pirates of Somalia: Ending the threat, rebuilding a nation. The World Bank Regional Vice-Presidency for Africa

²⁴ Durrieu, R. (2013). Rethinking money laundering & financing of terrorism in international law. Boston: Martinus Nijhoff.

²⁵ UNODC. (2011). Estimating illicit financial flows resulting from drug trafficking and other transnational organized crimes

²⁶ Simser, J. (2012). Money laundering: Predicate crimes, laundering techniques and the AML response. Emerging Issues 6195: Matthew Bender & Company. Inc

European RAND report of \$10 billion.²⁷ However, in order for this money to be accessed and used freely within the wider economy, at some point it needs to be entered into the legitimate financial system. 'Clean' money can be consumed, converted and invested easier and without being traced, while 'dirty' money can only be consumed in certain situations and leaves criminals exposed and at greater risk of being caught until the money has been cleansed. Dirty money, thus, has fewer uses, and it is therefore worth less".²⁸

In order to understand the risks that money laundering poses to global banking systems, AML officers need practical examples of how criminals are currently using and exploiting the banking sector. These are obviously difficult to acquire without breaching law enforcement protocols and risking current and ongoing investigations. Instead Financial Intelligence Units work with sanitised cases that have all the legal information removed.

For AML officers there are a number of publications that explain in detail how money laundering occurs using case examples, such as the APG report ²⁹ or the AUSTRAC reports ³⁰ both of which provide sanitized cases and typologies relating to a variety of different money laundering schemes that have been discovered. In addition, there are also country

²⁷ Kilmer, B & Pacula, R, L (2009) Estimating the size of the global drug market A demand –side approach.

²⁸ McCarthy, K. J., van Santen, P., & Fiedler, I. (2014). Modelling the money launderer: Micro theoretical arguments on anti-money laundering policy. *International Review of Law and Economics*. doi: 10.1016/j.irl.2014.04.00 p2

²⁹ APG. (2014). APG yearly typologies report 2014. Australia: APG. Methods and trends of Money Laundering and Terrorism Financing

³⁰ AUSTRAC. (2014). Typologies and case studies report. Australia: AUSTRAC. Retrieved from <http://www.austrac.gov.au/sites/default/files/typologies-report-2014.pdf>

specific reports which examine how AML strategies are working in detecting money laundering within the financial system such as AML issues in Chinese banks ³¹ and AML / CFT in the Irish Banking sector.³²

Despite the simplicity in the schemes that have been identified, the process of capturing money laundering activity and being able to attribute it to the actual criminals involved is far from simple.³³ The cases that have been identified in these reports do not explain the wider impact of the money laundering activity ³⁴ or give a full picture of what is not being caught.

In addition, and especially for TBML cases, the situations can be a lot more complicated than simplified case studies depict. The complexities of trade misinvoicing ³⁵ and the attempts to thwart it ³⁶ illustrate that the current money laundering techniques require an in-depth level of understanding of both trade finance practices and the opportunities available to criminals within the international shipping and trade sector. Whereas traditional money laundering schemes can often be applied generically across different countries and regions, in contrast TBML cases

³¹Identifying Anti-Money Laundering Issues in Chinese Banks. (2009). TEMENOS

³²Report on Anti-Money Laundering/Countering the Financing of Terrorism and Financial Sanctions Compliance in the Irish Banking Sector. (2015). Central Bank of Ireland.

³³Murray, K. (2013). A square go: Tackling organised crime where it doesn't want to be tackled. *Journal of Money Laundering Control*, 16(2), 99-108. doi:10.1108/13685201311318458

³⁴McDowell, J., & Novis, G. (2001). The consequences of money laundering and financial crime. *Economic Perspectives, An Electronic Journal of the U.S. Department of State*, 6(2)

³⁵Buehn, A., & Eichler, S. (2011). Trade misinvoicing: The dark side of world trade. *The World Economy*, 34(8), 1263-1287.

³⁶de Boyrie, M. E., Nelson, J. A., & Pak, S. J. (2007). Capital movement through trade misinvoicing: The case of Africa. *Journal of Financial Crime*, 14(4), 474-489. doi:10.1108/1359079071082818

have tended to be studied within more concentrated contexts either at a country or regional level.³⁷

Despite the additional trade context there are still some generalities that can be applied to all forms of money laundering activity. For example, the standard process whereby in order to hide the source of their income, criminals use a series of complex financial transactions to move money about and inter mingle it with other monies already in the system. Eventually it becomes fully integrated with legitimate funds and in so doing the criminal groups are able to “*disguise the source of financial assets*”.³⁸

The process described above is what is traditionally known as money laundering and banks can obviously play a major role, albeit often unknown, in facilitating this. However, the activity of money laundering and the criminal activities that produce such funds, which are often referred to as predicate offences, are two distinct and separate criminal activities.³⁹ It is only in recent times that money laundering itself has become recognized as a criminal activity. Instead the judicial focus was placed on establishing links between the criminal activity and the cash trail. The concept of money laundering as a crime in its own right is slowly gaining prominence in many countries⁴⁰ with the result that there is increasing pressure on

³⁷Yalta, A. Y., & Demir, I. (2010). The extent of trade mis-invoicing in turkey: Did post-1990 policies matter

³⁸ McDowell, J., & Novis, G. (2001). The Consequences of Money Laundering and Financial Crime. Economic Perspectives, An Electronic Journal of the U.S. Department of State, 6(2), 3-.

³⁹ McCarthy, K. J., van Santen, P., & Fiedler, I. (2014). Modelling the money launderer: Micro theoretical arguments on anti-money laundering policy. International Review of Law and Economics. doi: 10.1016/j.irl.2014.04.00

⁴⁰ Mugarura. (2012). The global AML framework and its jurisdictional limits. PhD

banks to be more vigilant and proactive, since they can now be inadvertently involved in a crime.

The risk to global banks of being caught in the middle of illicit financial transactions has increased even more with the advent of technology and electronic transfer and payment systems, which amongst other things have increased the speed of illicit money transfers. In addition, the introduction of virtual currencies ⁴¹ means that the nature of AML risk has changed dramatically since electronic payments cannot always be tracked or easily followed. Therefore, financial investigations are slower processes, which could potentially impact on banking resources, especially if law enforcement need their help and support in cases.

All of these advancements in technology have meant that the financial regulators have also changed their list of compliance requirements, which in some cases has left banks behind the system and vulnerable to financial investigations. Evidence of this can be seen in the results of a recent KPMG survey,⁴² which asked financial services firms from over 40 countries ⁴³ noting that recent changes such as the U.S.

⁴¹Keene, S. D. (2011). Emerging threats: Financial crime in the virtual world. *J of Money Laundering Control*, 15(1), 25-37. doi:10.1108/1368520121119471

⁴² KPMG. (2014). Global anti-money laundering survey. Retrieved from <https://www.kpmg.com/KY/en/IssuesAndInsights/ArticlesPublications/PublishingImages/global-anti-money-laundering-survey-v3.pdf>

⁴³The report presents the findings by region and doesn't actually name the countries involved other than on a general map which shows Canada, USA, Mexico, Bermuda, Ireland, Luxembourg, Austria, Portugal, Brazil, Netherlands, Sweden, Russia, United Kingdom, Denmark, Latvia, Poland, Germany, Slovakia, France, Switzerland, Andorra, Spain, Italy, Malta, Greece, Armenia, Jordan, Kuwait, Qatar, UAE, Saudi Arabia, India, Thailand, Hong Kong, Japan, Malaysia, Singapore, Indonesia, Australia, New Zealand, Ghana, Kenya, Angola, Zimbabwe, South Africa. However, in the methodology section it does state that "317 respondents participated in this year's survey representing 48 countries" KPMG (2014) p6

Foreign Account Tax Compliance Act and the Fourth European Money Laundering Directive have all meant that budgets for AML compliance were seriously underestimated for the third year running. Other countries are also noticing the difficulties and challenges of trying to implement regulation that is constantly changing and evolving, some countries such as Malaysia noted a significant impact on the banking sector ⁴⁴ whereas in Russia many banks were still struggling to implement even earlier forms of AML compliance.⁴⁵

1.2.2 Impact of Technology on Global Money Laundering Activity

There are many advantages to living in a globalised community with access to advanced technology and communication systems. In business and financial terms one of the main advantages is the increase with which business can be conducted, supported by faster and less cumbersome means to ship and transfer goods and faster mechanisms through which to receive or make payments. There is however also a downside to this phenomenon and that is witnessed through the increase in multi-national organised crime groups, who can quickly and effortlessly move illicit goods and their financial gains across the globe at the click of a button. In the

⁴⁴ Rahman, A. A. (2013). The impact of reporting suspicious transactions regime on banks: Malaysian experience. *J of Money Laundering Control*, 16(2), 159-170. doi:10.1108/13685201311318502

⁴⁵ Subbotina, N. (2009). Challenges that Russian banks face implementing the AML regulations. *J of Money Laundering Control*, 12(1), 19-32. doi:10.1108/13685200910922624

words of Arnone & Borlini (2010) ⁴⁶ '*The multi-faceted process of globalization has created new opportunities for transnational economic crime*'.⁴⁷

This growth in transnational crime can be witnessed in the projected estimates for global money laundering (ML) activity. These figures show that money laundering activity accounts for approximately 2-5% of the world's GDP ⁴⁸ with 50% of all money laundering activity occurring through the US banking sector.⁴⁹ In addition to the financial impact that money laundering has on the banking sector, ML also has a severe economic impact on countries across the world, this is due to the nature of both its direct and indirect effects.⁵⁰ These indirect effects can include increasing the political instability of countries due to the supply of arms to rebel and insurgent groups; or increasing illegal drug supplies into communities. The removal of money from weakened economies through illicit financial flows can also destroy community infrastructure by depleting governments of structural funds.⁵¹ ML can destroy the local economic structure by destabilising legitimate businesses and providing access to cheaper cash or credit for those businesses supporting the criminal organisations.⁵² The

⁴⁶ Arnone, M & Borlini, L. (2010) "International Anti-Money Laundering Programs." J of Money Laundering Control 13, no. 3: doi:10.1108/13685201011057136

⁴⁷ Arnone & Borlini (2010, p227)

⁴⁸ Takáts, E. (2007). A theory of "crying wolf": The economics of money laundering enforcement. Ana Lucia Corofnel. IMF Working Paper

⁴⁹ Unger, B., & van Waarden, F. (2009). How to dodge drowning in data? Rule- and risk-based anti money laundering policies compared. Review of Law & Economics, 5(2). doi:10.2202/1555-5879.142

⁵⁰ Arnone, M & Borlini, L. (2010) "International Anti-Money Laundering Programs." J of Money Laundering Control 13, no. 3: doi:10.1108/13685201011057136

⁵¹ Kar, D., & LeBlanc, B. (2013). Illicit financial flows from developing countries 2002-2011

⁵² McCarthy, K. J., van Santen, P., & Fiedler, I. (2014). Modelling the money launderer: Micro theoretical arguments on anti-money laundering policy. International Review of Law and Economics. doi: 10.1016/j.irle.2014.04.00

social and political impact of money laundering⁵³ means that international responses have been called for in order to address the scale of the problem. Organizations such as the FATF⁵⁴ have tried to address some of the concerns by producing a series of guidelines that focus on each of the various aspects of money laundering including best practices on TBML⁵⁵ and also virtual currency threats.⁵⁶ This has resulted in a number of agreed standards for AML compliance⁵⁷ that banks across the globe must adhere to, and which countries have agreed to monitor and supervise. The challenge to the banking sector is to try and turn these generic guidelines into working policies that can be administered practically within each specific local banking context.⁵⁸ Unfortunately, many of the guidelines have been developed to focus on simple money laundering techniques in

⁵³ McDowell, J., & Novis, G. (2001). The consequences of money laundering and financial crime. *Economic Perspectives*, An Electronic Journal of the U.S. Department of State, 6(2)

⁵⁴ Throughout the research there will be mention of the FATF organisation and generally it should be noted that what is being referred to are the current members of the FATF – current as in the date of compiling this research thesis.

“The Financial Action Task Force is a task force created by the G7 in 1989. It was originally created in response to the growing concern of the global drug problem. By the late 1980s, the prosperous global drug trade, was a concern for citizens and governments the world over. Both drugs, and drug money moved across borders freely, and national legislation and law enforcement seemed powerless to put a halt to it. The G7 ministers decided that a multinational approach was necessary to fight the international drug trade and to prevent the global misuse of the banking sector and other financial institutions to launder drug money. They created the FATF, which was tasked with developing international consensus on measures to detect and seize the proceeds from drug crime and other crimes. Its members were the G7 countries, the European Commission, and eight other countries. In 1990, a year after its creation, the FATF created the 40 Recommendations. These recommendations set out the legal and regulatory measures that countries should take to enable them to detect, prevent and punish the misuse of their financial system for money laundering. These measures were the turning point in the fight against money laundering. Up until then, most countries had no legal or regulatory provisions that were specifically targeted at detecting and punishing money laundering. For the first time, countries had powerful and effective tools at their disposal and an international consensus on how to fight money laundering of drug money at a global scale.”

FATF. (2014). "History of the FATF". FATF, Paris, France. Retrieved from FATF: <http://www.fatf-gafi.org/media/fatf/documents/brochuresannualreports/FATF%2025%20years.pdf>

⁵⁵ FATF. (2008). Best practices on trade based money laundering. France: Financial Action Task Force / OECD

⁵⁶ FATF. (2014). Virtual currency key definitions and potential AML/CFT risks. Paris. FATF Report

⁵⁷ FATF. (2012). International standards on combatting money laundering and the financing of terrorism & proliferation [The FATF Recommendations]

⁵⁸ Webb, L. (2004). A survey of money laundering reporting officers and their attitudes towards money laundering regulations. *Journal of Money Laundering Control*, 7(4), 367-375

isolation, whereas research ⁵⁹ would suggest that schemes like TBML, mix and match money laundering techniques. This means that AML red flags also need to become broader.

Despite the increased regulation and reporting procedures, criminals involved in laundering money have become increasingly more complex in their exploitation of financial products,⁶⁰ as a way to launder the proceeds of their illicit activity.⁶¹ As a result of these evolving techniques the industries and agencies that respond to money laundering (ML) activity have seen a continued increase in the growth of illicit funds entering the global economy.⁶² Within the area of financial crime ML is now recognised as possibly the biggest major problem, and constitutes the third largest 'business' in the world.⁶³

1.2.3 Trade Based Money Laundering (TBML)

TBML is one example of how money laundering systems have evolved in response to stricter AML controls.⁶⁴ In TBML scenarios criminal organisations and individuals disguise the source of their funds through

⁵⁹ Mauro, J. S. (2014). THE NEW ECONOMY IN FINANCIAL CRIMES . Understanding the effects of under-invoicing, double invoicing and false invoicing in trade-based money laundering and terrorist financing (TBML & TF) schemes [] (). ACAMS.

⁶⁰ Blum, J. A., Levi, M., Naylor, R. T., & Williams, P. (1998). Financial havens, banking secrecy and money-laundering

⁶¹ AUSTRAC. (2013). Typologies and case studies report 2013. Australia: AUSTRAC.

⁶² Kar, D., & LeBlanc, B. (2013). Illicit financial flows from developing countries 2002-2011

⁶³ Le-Khac, N. -A., & Kechadi, T. (2014). Toward a new cloud-based approach to preserve the privacy for detecting suspicious cases of money laundering in an investment bank. In International conference on computational science, (ICCS 2014), cairns, Australia, 10-12 June 2014

⁶⁴ Ferwerda, J. (2012). The Multidisciplinary Economics of Money Laundering. Printed by Ridderprint, Ridderkerk, Tjalling C. Koopmans Dissertation Series

the use of trade and international shipping transactions.⁶⁵ These type of activities are harder to detect for the banking system because they involve multiple bank accounts and traverse several jurisdictions. In addition, it is difficult to verify the trading documentation that is presented to the bank without some level of expertise in international shipments. Since it is a newer form of money laundering technique, case studies and real life scenarios are scarce and provide a limited source from which to develop indicators and red flags, although some financial intelligence units have begun this process.⁶⁶ Some guidelines on TBML indicators have also been developed by the international advisory body FATF (Financial Action Task Force) in 2006 and updated in 2008.

1.2.3.1 Financial Action Task Force

The Financial Action Task Force (FATF)⁶⁷ is an inter-governmental body comprised of Ministers from each of the 34 member countries⁶⁸. The

⁶⁵ FATF. (2008). Trade based money laundering. France. Financial Action Task Force

⁶⁶ APG. (2012). APG Typology Report on Trade Based Money Laundering. Sydney: Asia Pacific Group on Money Laundering

⁶⁷ "The Financial Action Task Force is a task force created by the G7 in 1989. It was originally created in response to the growing concern of the global drug problem. By the late 1980s, the prosperous global drug trade, was a concern for citizens and governments the world over. Both drugs, and drug money moved across borders freely, and national legislation and law enforcement seemed powerless to put a halt to it. The G7 ministers decided that a multinational approach was necessary to fight the international drug trade and to prevent the global misuse of the banking sector and other financial institutions to launder drug money. They created the FATF, which was tasked with developing international consensus on measures to detect and seize the proceeds from drug crime and other crimes. Its members were the G7 countries, the European Commission, and eight other countries. In 1990, a year after its creation, the FATF created the 40 Recommendations. These recommendations set out the legal and regulatory measures that countries should take to enable them to detect, prevent and punish the misuse of their financial system for money laundering. These measures were the turning point in the fight against money laundering. Up until then, most countries had no legal or regulatory provisions that were specifically targeted at detecting and punishing money laundering. For the first time, countries had powerful and effective tools at their disposal and an international consensus on how to fight money laundering of drug money at a global scale."

FATF. (2014). "History of the FATF". FATF, Paris, France. Retrieved from FATF: <http://www.fatf-gafi.org/media/fatf/documents/brochuresannualreports/FATF%2025%20years.pdf>

group was first established in 1989 and aims to monitor every member country for vulnerabilities and weaknesses in the country's approach to addressing money laundering and terrorist financing.

“The objectives of the FATF are to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system”.⁶⁹

As part of their remit FATF have developed a series of recommendations, the main framework on money laundering was published in 2012 with additional publications on specialised areas and ML schemes being added. These recommendations provide the basis for a global framework of AML standards, which can assist and guide banks to detect money laundering type activity and to raise red flags or alerts.⁷⁰ As part of their ongoing role FATF have assumed a role of monitoring individual country progress, and analysing how they are implementing these guidelines. The results of these findings are published as a series of annual country reports, which also inform other countries of progress and/or areas of concern within a specific region. These country reports can then be incorporated into the risk assessment framework of individual

⁶⁸ Throughout the research there will be mention of the FATF organisation and generally it should be noted that what is being referred to are the current members of the FATF – current as in the date of compiling this research thesis.

⁶⁹ FATF (2015) Who we are <http://www.fatf-gafi.org/pages/aboutus/>

⁷⁰ FATF. (2012). International standards on combatting money laundering and the financing of terrorism & proliferation [The FATF Recommendations]

banks, to check if their client's businesses have financial transactions or trading agreements in those areas deemed to be at additional risk.

FATF was originally developed to address money laundering concerns linked to the movement of cash by drug cartels. However, its remit has expanded over time and now includes all types of money laundering and terrorist finance risks including TBML. This has led to criticism that by trying to be all things to all people their guidelines and material is very generic and hard to translate into practical and working guidelines,⁷¹ which was also a message that came through from this research data.

As part of their role FATF has sought to actively encourage a dynamic and responsive risk based approach rather than a rigid rules based system, stating that it is more flexible and responsive. They highlight the inherent risk within a strict rules based approach, which they state tends to encourage a tick box attitude without real consideration of the actual risks.⁷² The approach suggested by FATF has sometimes been criticised for failing to provide clearer guidance for banks on the kinds of scenarios to expect and even whether the definition FATF provides for TBML is really adequate.⁷³

⁷¹Soudijn, M. (2014). A Critical Approach to Trade-Based Money Laundering. *Journal of Money Laundering Control* Vol 17, Iss 2, 230-242

⁷²FATF. (2006). Trade based money laundering. France. Financial Action Task Force

⁷³Soudijn, M. (2014). A Critical Approach to Trade-Based Money Laundering. *Journal of Money Laundering Control* Vol 17, Iss 2, 230-242

“.....precisely because the FATF is accorded such high status and is involved in inspecting the implementation of anti-money-laundering policies in its member countries, one would expect the reports to be exempt from criticism. It is strange, then, that the definition is somewhat ambiguous and contains inconsistencies and undeveloped terms”.⁷⁴

The nature of TBML means that criminals are always fluctuating and adapting their approach to respond to the AML regulation in the region.⁷⁵ However, research critics on TBML and most notably Soudijn, who is from a law enforcement background, have suggested that crime displacement may not be accurate since we do not actually have enough data or research on this topic to be able to make such claims at this stage.

“As it turns out, nobody, including the FATF, really knows if TBML results from crime displacement. There is a simple explanation for this lack of knowledge: the non-existence of sufficient empirical data”.⁷⁶

In response to some of these concerns and most notably about the lack of understanding of TBML, this research aims to explore whether

⁷⁴Soudijn, M (2014) A Critical Approach to Trade-Based Money Laundering. Journal of Money Laundering Control Vol 17, Iss 2, p233

⁷⁵ Ferwerda, J. (2012). The Multidisciplinary Economics of Money Laundering. Printed by Ridderprint, Ridderkerk, Tjalling C. Koopmans Dissertation Series.

⁷⁶Soudijn, M. (2014). A Critical Approach to Trade-Based Money Laundering. Journal of Money Laundering Control Vol 17, Iss 2, p231

clearer support guidelines can still be developed despite the changing nature of TBML schemes.

1.2.3.2 Suspicious Alerts

As part of the international response recommended by FATF, all countries should establish a financial intelligence unit or FIU to analyse data and intelligence sent on by financial services including banks.⁷⁷ This data is received in the form of a suspicious transaction report (STR), or sometimes called a suspicious activity report (SAR) depending on the country or jurisdiction. Whenever a transaction or client might be considered involved in any criminal laundering activity, alerts are passed onto the centralised financial intelligence unit (FIU) within each country. This process has an administrative cost to the banks, which may explain some of their reluctance to invest too many resources into this work, for example; the Permanent Subcommittee on Investigations in the United States investigated the HBUS bank (part of HSBC) in 2012. They discovered as part of this investigation that 15,000 SARs had been reported internally in the bank but that these were still waiting to be sent onto the FIU. The backlog was reportedly due to a lack of dedicated staff to the AML compliance unit.⁷⁸

⁷⁷ FATF. (2012). International standards on combatting money laundering and the financing of terrorism & proliferation [The FATF Recommendations]

⁷⁸ Homeland Security. (2012). HSBC exposed US financial system to money laundering, drug, terrorist financing risks. From permanent sub committee on investigations. US Senate. Retrieved from <http://www.hsgac.senate.gov/subcommittees/investigations/media/hsbc-exposed-us-finacial-system-to-money-laundering-drug-terrorist-financing-risks>

Suspicious reports can only work if the system of risk assessment is able to detect what the suspicious behaviour is. If risk assessment framework has not incorporated the relevant risks associated with TBML activity, then it is unlikely to be raised as a potential SAR.

Other media cases have highlighted that the definition of suspicious activity can vary and some banks have taken different approaches towards reporting the client's suspicious use of offshore accounts.⁷⁹ The reporting of suspicious activity is a key cornerstone of AML compliance and fundamental differences such as these, amongst banks provide gaps in the system that can be further exploited by financial criminals.

The lack of an internationally agreed definition of 'suspicious' is still a potential stumbling block for many banks.⁸⁰ Some countries such as the UK⁸¹ have opted for a very wide legal interpretation of what suspicious activity might involve, whereas the banking sector is looking for a more focused and specific definition that they can link to a risk assessment framework. It can be said that at one extreme we have a very focused definition held by the United Kingdom, and on another extreme we have the approach taken by Switzerland, whereby they have adopted a statutory definition seen to be very narrow, with a process obligating the bank to compile a report if it is grounded in evidence that a client has committed a criminal act or that his proceeds are of criminal activity. Police

⁷⁹ Fitzgibbon, W & Hamilton, M.M. (2015b) Bank's Services for Arms Dealers in Conflict with Its Own Policy <http://www.icij.org/project/swiss-leaks/banks-services-arms-dealers-conflict-its-own-policy>

⁸⁰ Retrieved from <https://www.finma.ch/FinmaArchiv/ebk/d/regulier/pdf/gwv-181202-e.pdf>
<http://www.austrac.gov.au/typologies-2010-smr>

<http://www.bailii.org/ew/cases/EWCA/Crim/2006/1654.html>

⁸¹ <http://www.bailii.org/ew/cases/EWCA/Crim/2006/1654.html>

enquiries commence after the banks submit their report. A third example of the differing definition is seen in the Australian definition which is similar to the United Kingdom albeit censored a little further, whereby the Australia's legislation⁸² seems to be written differently⁸³ from the UK's and focussed far more on false documentation than criminal proceeds, and suspicion.⁸⁴

The Wolfsberg Trade Finance principles, which were developed by a cluster of the world's largest banks, have also suggested areas that could be deemed suspicious. However even with these principles the focus is still on providing examples and research material. Within an individual bank an AML officer needs to be able to interpret all this information, and then turn it into a working risk assessment system that can be implemented within his or her own bank.

The reporting of suspicious activity is a cornerstone of AML compliance; however, fundamental differences in definitions amongst

⁸² Australian Government. (2006). "Anti-Money Laundering and Counter-Terrorism Financing Act 2006". Federal Register of Legislation, Australian Government, Australia. Available at: <https://www.legislation.gov.au/Details/C2016C00770>

⁸³ Haynes, A. "A COMPARATIVE ANALYSIS OF THE EFFECTIVENESS OF THREE DIFFERENT APPROACHES TO COMBATING MONEY LAUNDERING". POLICING IN CENTRAL AND EASTERN EUROPE: Comparing Firsthand Knowledge with Experience from the West, © 1996 College of Police and Security Studies, Slovenia <https://www.ncjrs.gov/policing/com291.htm>

⁸⁴ AUSTRAC, in Public Legal Interpretation No 6 of 2008 – Suspect Transactions and suspicious matter reports, concludes that the requirement of "reasonable grounds to suspect" in the FTR Act and "suspects on reasonable grounds" in the AML Act are essentially the same. That is, the reporting entity must have a "real suspicion of the relevant matters [the subjective element] and the suspicion must be based on matters or evidence that support the truth of the suspicion [the objective element]". A suspicious matter report to AUSTRAC under the AML Act must also contain a statement of the grounds on which the reporting entity holds the relevant suspicion <https://antifraudnetwork.com/2009/06/%E2%80%99Creasonable-grounds%E2%80%99D-in-suspicious-matter-reporting%E2%80%94the-uk-and-australian-perspective/>

states and inevitably banks create vulnerabilities in the system that can be further exploited by financial criminals.⁸⁵

The lack of an internationally agreed definition of ‘suspicious activity’ is still a potential obstacle for many banks.⁸⁶ A comparison of how various countries interpret “suspicious activity” is helpful in understanding how AML regulations remain pervasive.⁸⁷

Suspicious Activity Reports (SARs) are tools the FATF (Financial Action Task Force) recommends as a first line of defence in detecting money laundering and trade based money laundering activity. SARs are a granular level measure of the potential laundering threat of any particular system. How banks and other financial institutions approach SARs, and how governments define them, illustrates differences in how various systems define suspicious activity.

All financial institutions in countries that are members of the FATF⁸⁸ are required to install procedures, and training, in order to better detect and respond to suspicious activity. They require banks to complete an official report of suspicious activity noticed by staff, and forward it to the authorities. By comparing a country’s requirements for an SAR and the

⁸⁵ Fitzgibbon, W & Hamilton, M.M. (2015b) Bank’s Services for Arms Dealers in Conflict with Its Own Policy <http://www.icij.org/project/swiss-leaks/banks-services-arms-dealers-conflict-its-own-policy>

⁸⁶ Anon. 2002 Ordinance of the Swiss Federal Banking Commission Concerning the Prevention of Money Laundering Retrieved from: <https://www.finma.ch/FinmaArchiv/ebk/d/regulier/pdf/gwv-181202-e.pdf> (Accessed 10 December 2016)

Anon. 2014, Suspicious matter reports [web page] <http://www.austrac.gov.au/typologies-2010-smr> (Accessed 10 December 2016)

⁸⁷ <http://www.austrac.gov.au/typologies-2010-smr>

⁸⁸ See Footnote 54

number of SARs submitted, we develop an idea of how varied the definition of “suspicious activity” is.

In 2012, the USA recorded 860, 858 SRAs, whereas Brazil’s financial institutions reported only 38, 417 incidents.⁸⁹ Given that Brazil’s economy and financial sector is of relative sophistication and size to the USA’s, the non-relative difference in SRAs indicates a difference in attitude and interpretation of “suspicious activity”.

A shell bank is a bank that does not have a physical address in the country from which it operates. The FATF strongly recommends against transacting with shell banks.⁹⁰ Despite this, a number of countries that are members of the FATF do not specifically prohibit their banks from doing business with shell banks; examples include Argentina, Japan and Finland.⁹¹ This is another indication of how malleable the definitions within AML regulations are. This, again, describes differences in attitudes and interpretations of FATF and standard AML regulations.

The Wolfsberg Trade Finance Principles, updated as recently as January 2017, acknowledge that the differences in interpretation of the AML regulations are less an indication of deliberate resistance to AML, and rather a function of immaturity within a financial sector’s

⁸⁹ Kihhl. A 2015 USA and Brazil Audit Comparative Analyses. Advanced Financial Crime Professionals Worldwide. p. 20

⁹⁰ Anon. 2012. International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation. FAFT, Paris. Retrieved from: http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf (Accessed on 20 February 2017)

⁹¹ Pwc. 2012, Know your customer quick reference guide. Retrieved from: <https://www.pwc.com/gx/en/financial-services/assets/pwc-kyc-anti-money-laundering-guide-2013.pdf> (Accessed on 19 February 2017)

development.⁹² Nonetheless, differences exist – for one reason or another - and risk mitigation when analysing a client's transactions absolutely requires an understanding of AML statutory and institutional differences between countries, particularly with regard to trade transactions, where partner banks in other territories will be required to collect, validate and interrogate documentation pursuant to a client's trade transaction.

In essence the complexity⁹³ of criminal schemes and money laundering activities is continually evolving;⁹⁴ this is partly in response to the banks tightening their AML screening processes and therefore criminals needing newer schemes in order to circumvent them. However, the AML structures and systems at a global banking level are perhaps adapting more slowly than the criminal schemes since there is a time delay between new ML schemes being identified and recognised and the new structures to defeat them being implemented. This delay is because the process of developing new schemes is quite complex and requires a thorough understanding of how the schemes actually operate, followed by

⁹²Anon. 2017, The Wolfsberg Group, ICC and BAFT Trade Finance Principles, Wolfsberg Group. Retrieved from: <http://www.wolfsberg-principles.com/pdf/home/Trade-Finance-Principles-Wolfsberg-Group-ICC-and-the-BAFT-2017.pdf> (Accessed on 20 February 2017)

⁹³ APG. (2012). APG Typology Report on Trade Based Money Laundering. Sydney: Asia Pacific Group on Money Laundering.

PwC. (2014). Goods gone bad. Addressing money-laundering risk in the trade finance system.

⁹⁴ Kook, S. Financial Action Task Force (FATF) Evolving in its Effort to Combat Money Laundering and Terrorist Financing, Department of Treasury, Treasury Notes, March 23, 2013, at <https://www.treasury.gov/connect/blog/Pages/Financial-Action-Task-Force-%28FATF%29-Evolving-in-its-Effort-to-Combat-Money-Laundering-and-Terrorist-Financing.aspx>.

U.S. Department of the Treasury, National Money Laundering Risk Assessment, June 12, 2015, at <https://www.treasury.gov/resource-center/terrorist-illicit-finance/Documents/National%20Money%20Laundering%20Risk%20Assessment%20%E2%80%932006-12-2015.pdf>.

Financial Crimes Enforcement Network (FinCEN), Advisory to Financial Institutions on Filing Suspicious Activity Reports Regarding Trade-Based Money Laundering, advisory, FIN-2010-A001, February 18, 2010.

Le-Khac, N. -A., & Kechadi, T. (2014). Toward a new cloud-based approach to preserve the privacy for detecting suspicious cases of money laundering in an investment bank. In International conference on computational science, (ICCS 2014), Cairns, Australia, 10-12 June 2014.

a process of identifying how they managed to bypass the banking screening system. The lack of specific guidance provided by bodies such as FATF means that individual banks have to develop schemes and risk assessment processes on their own. This issue is further compounded by different legislative interpretations of money laundering crimes and the link to predicate offences. In some countries money laundering has only recently been seen as a crime in its own right,⁹⁵ which is all a bank can raise suspicion about. In other countries evidence of a predicate offence i.e. the source of the money coming from a crime has to be determined before it will be deemed as a money laundering crime. In either scenario, stronger links between outside agencies such as law enforcement, customs and tax offices is needed with the banking sector in order to develop a fuller picture of potential money laundering crimes that the legal system can utilise.

The FATF guidelines on TBML provide some generic case scenarios and red flag indicators, but they fail to go further than this. Banks are therefore challenged to develop a system that reflects their individual country needs, as well as utilizing the skills within the bank to incorporate the red flags in a way that is meaningful and can be used in a risk assessment process.

⁹⁵ "It follows from the simple definition above that money laundering cannot occur without being preceded by a crime which gives rise to the illegally obtained funds. Such crimes are called 'predicate crimes'. Countries differ in what they define as predicate crimes and what they define as money laundering. Each country's definition is critical because if a crime is not a predicate crime then there is no money laundering activity" taken from "Module 3: Notes Money Laundering and Terrorist Financing – Definitions and Nature" of Advanced Certification in Anti Money Laundering. International Compliance Training Ltd England. Source: www.int-comp.com/members/attachments/Mal-module3.pdf

1.2.3.3 Comparative AML Approaches With a Focus on the United Kingdom

A brief overview of the United Kingdom's AML legislation and enforcement is valuable, especially as London is considered one of the world's major financial centres. The UK's POCA (Proceeds of Crime Act) came into effect in 2002, and replaced laws that were considered too specific to drug related offenses. Tracking the reasons for the new laws, and their passage into law is useful in discovering legislative realities and challenges of implementing AML laws. Constant review is another aspect of the UK's AML legislative process, POCA has subsequently endured a range of critiques, particularly with regard to enforcement; we will briefly explore how the UK's ongoing institutional development of AML enforcement has proceeded within both existing sector bodies, as well as newly established enforcement agencies.

1.2.3.4 Proceeds of Crime Act (POCA)

The Proceeds of Crime Act (POCA)⁹⁶ enacted in 2002, contained the UK Judiciary's provisions for the detection and prosecution of money laundering offences. The logic was immutable, at the time the Home Office stated, "The aim of the asset recovery scheme in POCA is to deny criminals the use of their assets, recover the proceeds of crime, and deter

⁹⁶ UK Government. (2002). "Proceeds of Crime Act 2002". UK Parliament. Available at: www.legislation.gov.uk/ukpga/2002/29/contents

and disrupt criminality”.⁹⁷ Exploring sections 327 – 329⁹⁸ of POCA provides an overview of the statutory mechanisms the UK uses in its fight against money laundering. It is also of benefit to study the Home Affairs Select Committee’s report (2016) on the proceeds of crime, which is all but damning of the enforcement and supervision structures issuing from POCA with specific regard to money laundering.

Criminal property is defined in POCA as either “a person’s benefit from criminal conduct or a representation of that benefit or the alleged offender knows or suspects that the property constitutes or represents such a benefit.” Section 327 of POCA defines what concealment of criminal property means. Concealment of criminal property is the disguise, conversion, transfer or removal of criminal property. Section 328 concerns itself with arrangements and labels as an offence, anyone entering into or becoming concerned in an arrangement which he knows or suspects facilitates the acquisition, retention, use or control of criminal property. Section 328 speaks to use and acquisition of criminal property, it is an offence to be in possession of, acquire or use criminal property.

1.2.3.5 POCA Case Law

Section 328 has been further refined in cases such as *R v GH* (Respondent) [2015] UKSC 24, 22 April 2015. The Supreme Court found

⁹⁷ Written submission by the Home Office on enacting POCA 2002. Retrieved from: <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/home-affairs-committee/proceeds-of-crime/written/29812.html>

⁹⁸ <http://www.legislation.gov.uk/ukpga/2002/29/section/327>
<http://www.legislation.gov.uk/ukpga/2002/29/section/328>
<http://www.legislation.gov.uk/ukpga/2002/29/section/329>

that any arrangement entered into prior to the existence of criminal property, could not be tried as a money laundering offence.⁹⁹ This is naturally of importance to banks and investment institutions who may unwittingly open bank accounts for criminals who intend to obtain criminal property, but have yet to commit an actual crime. The findings in *JSC BTA Bank v Ablyazov* [2009] EWCA Civ 1124 at para 14 also speak to the importance of criminal property existing prior to an arrangement for money laundering to have occurred.¹⁰⁰ Finally *R v Sarwar* [2011] HCJAC 13, makes interesting reading with regard to “knowing or suspecting”. Here the court finds that prosecutions must be able to prove an offender knew or suspected the property was criminal property in order for the offender to be charged with money laundering.¹⁰¹

1.2.3.6 POCA Analysis

There are successful aspects to POCA: prior to POCA prosecutors had to prove an underlying crime before they could argue the crime of money laundering, POCA created a single set of money laundering offences applicable in all circumstances, without regard to the precise

⁹⁹ United Kingdom Supreme Court. "Judgement *R v GH (Respondent)*". (2015). United Kingdom Supreme Court. Available at: https://www.supremecourt.uk/decided-cases/docs/UKSC_2014_0035_Judgment.pdf Cited as : [2015] 2 Cr App R 12, [2015] Lloyd's Rep FC 387, [2015] UKSC 24, [2015] WLR(D) 178, [2015] 1 WLR 2126, [2015] WLR 2126, [2015] Crim LR 637, [2015] 4 All ER 274 Available at : www.bailii.org/uk/cases/UKSC/2015/24.html.

¹⁰⁰ England and Wales Court of Appeal. (2010). "*JSC BTA Bank v Ablyazov & Ors* [2009]". England and Wales Court of Appeal (Civil Division) Decisions. Available at: www.bailii.org/ew/cases/EWCA/Civ/2009/1124.html. Cited as: [2010] 1 WLR 976, [2010] 1 Cr App R 9, [2009] EWCA Civ 1124, [2010] CP Rep 8, [2010] 1 Cr App Rep 9, [2010] Lloyd's Rep FC 105.

¹⁰¹ Fisher, Jonathon. (2011). "North and South - English and Scots case law". Money Laundering Bulletin. May 2011 Issue. Informa UK Ltd. Available at: http://devereuxchambers.co.uk/assets/docs/publications/money_laundering_-_jonathon_fisher.pdf

nature of the base crime. In fact, no prosecution for the criminal offence is required for the prosecution of the money laundering offence to occur.¹⁰²

Criticism of the UK's POCA legislation was focused on the confiscation regime and enforcement it created.¹⁰³ The Home Office enquiry of 2016¹⁰⁴ was motivated by a set of startling figures: statistics from 2014-15 showed that 640,000 individuals were convicted of a crime in the UK, and over the same period, 5,924 confiscation orders were made; less than 1% of convictions.¹⁰⁵ Of the approximately one thousand confiscation orders used to freeze assets, 45% of those were enforced. In addition, the enforcement of orders appeared to have a higher rate of success where the amount of the assets involved was £1000 or less (a rate of 96%) as compared to those involving assets valued over £1 million (a rate of 22%). At the time there were at least 15 bodies¹⁰⁶ administering

¹⁰² Rupp, J et al 2011. Serious Economic Crime A Boardroom guide to Prevention and Compliance. Serious Fraud Office. Whitehall Retrieved from: <https://www.cov.com/~media/files/corporate/publications/2011/10/the-proceeds-of-crime-act-2002-and-the-prosecution-of-economic-crime.pdf>

¹⁰³ Marshall, P., 2003. CRIMINAL CONDUCT UNDER PART 7 OF THE PROCEEDS OF CRIME ACT 2002: A REQUIREMENT FOR DOUBLE CRIMINALITY?. BUTTERWORTHS JOURNAL OF INTERNATIONAL BANKING AND FINANCIAL LAW, 18(6), pp.233-238

Comments of Professor Micheal Levi, Professor of criminology at the University of Cardiff taken from Kochan, N. (2016). "Why UK's POCA has failed to deliver a fit-for-purpose confiscation regime ". Available at: <https://www.wolterskluwerfs.com/article/why-uk-poca-has-failed.aspx>

¹⁰⁴ Commons Select Committee. (2016) "nd London's "welcome mat" for money launderers, says Committee". UK Parliament. Available at: <https://www.parliament.uk/business/committees/committees-a-z/commons-select/home-affairs-committee/news-parliament-2015/proceeds-of-crime-report-published-16-17/>

¹⁰⁵ Sheen, S 2016 'UK's Proceeds of Crime Act 2002 ("POCA") and Criminal Asset Confiscation'[web article] Retrieved from: <http://www.acams.org/aml-resources/samantha-sheens-blog/uks-proceeds-of-crime-act-2002/>

¹⁰⁶ The 15 Bodies are Home Office (Responsible for government policy on criminal finances and asset recovery), National Crime Agency (Responsible for training and accreditation of financial investigators. Also conducts its own financial investigations into some serious and organised crimes), Ministry of Justice (Responsible for government policy on the criminal, civil and family justice systems for England and Wales. Oversees the courts, prisons and legal aid bodies involved with confiscation orders), HM Courts & Tribunals Service (Overall responsibility for enforcing orders and reporting on them in its annual Trust Statement), National Offender Management Service (Responsible for prisoners, including those serving for not paying confiscation orders), Legal Aid Agency (Provides legal aid to offenders subject to confiscation proceedings, including administration of means testing to decide legal aid entitlement), Crown Prosecution Service (Responsible for

confiscation orders leading to an unnecessarily complicated and confusing scenario. Key findings of the committee included:

- At least a hundred billion pounds, equivalent to the GDP of Ukraine, is being laundered through the UK every year.
- Keith Vaz, a member of the UK parliament who chaired the select commons committee stated *"The main method of reporting suspicious transactions, the ELMER system, is not fit for purpose. Designed to identify money laundering or terrorist financing, it is desperately overloaded to the point where it is now completely ineffective. Capable of managing 20,000 reports a year, it is currently burdened with 381,882. This has rendered the whole system a futile and impotent weapon in the global fight against criminal financing, with no indication from the Home Office as to when a new state of the art system will be purchased"*.¹⁰⁷

prosecuting cases and enforcing the more complex, high-value orders), Serious Fraud Office (Responsible for investigating, prosecuting and enforcing the complex, high-value cases related to fraud, bribery and corruption), HM Revenue & Customs (Carries out financial investigations into tax cases, and assists HM Courts & Tribunals Service with related confiscation order enforcement), Department for Work & Pensions (Carries out financial investigations into benefits cases), National Police Chiefs' Council (NPCC) (Replaced the Association of Chief Police Officers (ACPO) in April 2015. Professional forum for the chief police officers in England, Wales and Northern Ireland to share ideas and best practice and, in some areas, coordinate resources), Regional Asset Recovery Teams (RARTs) (Regional teams responsible for investigating more complex cases, often on behalf of other law enforcement agencies), Asset Confiscation Enforcement teams (ACE) (Teams responsible for providing financial investigator support to enforcement agencies - including regional teams co-located with RARTs), Police forces (Carry out criminal and financial investigations on a wide range of crimes and criminals), Crown Court judges (Make judgments regarding confiscation order imposition), Magistrates (Make judgments on enforcement processes, including imposing default prison sentences), and Receivers (Private companies appointed by the courts to either manage or collect criminal assets).

Ref: National Audit Office (NAO). (2016). "Confiscation Orders: Progress Review". National Audit Office (NAO), United Kingdom. Available at: <https://www.nao.org.uk/wp-content/uploads/2016/03/Confiscation-orders-progress-review.pdf>

¹⁰⁷ Comments of Rt Hon Keith Vaz MP, Chair of the Commons Select Committee, UK Parliament. (Commons Select Committee. (2016) "End London's "welcome mat" for money launderers, says Committee". UK Parliament. Available at: <https://www.parliament.uk/business/committees/committees-a-z/commons-select/home-affairs-committee/news-parliament-2015/proceeds-of-crime-report-published-16-17/>)

- Investigators are delaying in freezing assets, ideally, assets should be frozen simultaneously with the criminal becoming aware of the investigation for the first time (this will often be at the time of arrest, although not always). Waiting for a conviction is far too late.
- There is a lack of interest in confiscation orders among prosecutors and judges, which has led in turn to a lack of training and specialist skills. Specialist courts would enable complex confiscation hearings to be dealt with more efficiently and with much greater expertise.¹⁰⁸
- The Parliamentary Home Affairs Select Committee's verdict¹⁰⁹ was damning stating that huge gaps existed in the Kingdom's efforts to tackle money laundering, trade based money laundering and other financial crimes, effectively undermining the authority of the AML Framework of the United Kingdom.¹¹⁰

1.2.3.7 POCA Amendments Since 2002

Since initially being written into law in 2002, POCA has been subsequently amended by the addition of the Serious Crime Act 2015, and as well as amendments via amendments to the Policing and Crime Act 2009, and the Crime and Courts Act 2013. All three amendments were

¹⁰⁸ House Of Commons Home Affairs Committee on Proceeds of Crime: Report 2016. Retrieved from: <https://www.publications.parliament.uk/pa/cm201617/cmselect/cmhaff/25/25.pdf>

¹⁰⁹ <https://www.parliament.uk/business/committees/committees-a-z/commons-select/home-affairs-committee/news-parliament-2015/proceeds-of-crime-report-published-16-17/>

¹¹⁰ Murray, K., 2010. Dismantling organised crime groups through enforcement of the POCA money laundering offences. *Journal of Money Laundering Control*, 13(1), pp.7-14.

written into law in 2015. Confiscation orders were altered with the addition of the determination of third party interests, the timing of confiscation orders (now payable on the day they are made), and far reaching powers provided to the court in the enforcement of compliance of confiscation orders. Sentencing scales were also amended, with longer sentences being recommended ranging from 6 months to 14 years and ending automatic release at the halfway point for orders in excess of £10 million. Restraint orders had also been made easier to obtain by lowering the threshold from 'belief' to 'suspicion'. The definition of cash detention had also been extended to cover items of value such as cars, watches, jewellery and furniture. Finally, the onus was now on the respondent/interested party to indicate that he objected to the forfeiture of cash otherwise it would take place without a hearing.

The changes have received critical reviews ¹¹¹ from those within the legal industry.¹¹²

¹¹¹ House of Commons Home Affairs Committee Proceeds of crime Fifth Report of Session 2016–17 Available at : <https://www.publications.parliament.uk/pa/cm201617/cmselect/cmhaff/25/25.pdf> "Many witnesses pointed out that asset recovery and proceeds of crime were seen as being a very niche area of law which neither prosecutors nor judges were enthusiastic about pursuing as a specialism." For example Mr Jeffrey Bryant (POC0016), NPCC Financial Investigation and Proceeds of Crime Portfolio (POC0011) and Royal United Services Institute (POC0004).

(POC0016) Written evidence submitted by Jeffrey Bryant available at: data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/home-affairs-committee/proceeds-of-crime/written/29608.html

(POC0011) Written evidence submitted by the NPCC Financial Investigation and Proceeds of Crime Portfolio available at: data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/home-affairs-committee/proceeds-of-crime/written/29572.html

(POC0004) Written evidence submitted by Helena Wood of the Centre for Financial Crime and Security Studies (CFCS) at the Royal United Services Institute (RUSI) available at: data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/home-affairs-committee/proceeds-of-crime/written/28764.html

¹¹² Sentencing remarks in *R v Innospec Ltd* (2010) by Lord Justice Thomas: "The Proceeds of Crime Act 2002 and the prosecution of economic crime". Covington & Burling LLP, London, UK. Available at: <https://www.cov.com/~media/files/corporate/publications/2011/10/the-proceeds-of-crime-act-2002-and-the-prosecution-of-economic-crime.pdf>

“Some of the amendments are almost eye watering and their supposed practical effect simply does not reflect the realities faced by criminal lawyers routinely engaged in the application and enforcement of confiscation orders. The idea that there are thousands of criminals languishing in prison instead of using concealed assets to repay confiscation orders is frankly delusional and the amendments made to the Act appear to be nothing more than political window dressing. The simple fact of the matter is that they are likely to lead to further injustice and further extensive litigation in the Appellate Courts of this country which had just started to get to grips with the sharper edges of the current regime”.¹¹³

1.2.4 International Review

The UK's teething problems with AML regulations and institutional development are not unique. When assessing other jurisdictions and their AML frameworks, the FATF reports are a reasonable starting point for assessing the country and understanding its AML risks, although as a caveat the FATF has also been criticised for its differential application of

¹¹³ Wilson, Brett. "POCA: Major changes now in force". (2015) . THE BRETT WILSON CRIMINAL, FRAUD AND REGULATORY LAW BLOG. Available at : <http://www.brettwilson.co.uk/blog/poca-major-changes-now-in-force/> Brett Wilson LLP in Farringdon, London offers expert guidance in business crime, regulatory, fraud, defamation and privacy cases across England and Wales.

standards from one country to another.¹¹⁴ In the following paragraphs I briefly explore a few AML models by country (Spain, Malaysia and Australia).

Comparing these countries offers a small yet powerful comparative sample that allows comparison and contrast across diverse verticals such as FATF ranking, economy size, sector exposure, risk profile and geography. These particular four countries are useful to compare for a number of reasons. The first is that they are all members of the FATF¹¹⁵ – Financial Action Task Force – meaning they have all been reviewed by the organization with specific focus on their AML regulations and enforcement. In this sense, there is a useful set of measurables, across which each country has been rated using a standardized methodology. The UK was included as London is currently considered the financial capital of the world.¹¹⁶ As such, one can make a reasonable assumption such a country would experience high rates of money laundering incidents, comparing their AML approaches is therefore insightful. As a parallel, the Basel AML index report of 2016,¹¹⁷ names Malaysia and Australia as amongst the five countries with the lowest AML risk. It is therefore also useful to compare their AML regulations with both each other, as well as higher risk countries. Spain, as both a member of the EU, as well as a major port of

¹¹⁴ Gilmore, W & Levi, M 2002, 'Terrorist Finance, Money Laundering and the Rise and Rise of Mutual Evaluation: A New Paradigm for Crime Control?' *European Journal of Law Reform*, vol 4, no. 2, pp. 337-64.

¹¹⁵ See Footnote 54

¹¹⁶ GFCI 20 Mark Yeandle and Michael Mainelli, Z/Yen Group Limited (Z/Yen Group, September 2016) Available at: www.longfinance.net/images/gfci/20/GFCI20_26Sep2016.pdf

¹¹⁷ "Fighting money laundering remains weak in most countries according to Basel AML Index 2016". (2016) Basel Institute of Governance, Basel, Switzerland. Available at: https://index.baselgovernance.org/sites/index/documents/Basel%20AML%20Index%202016_Media%20Release.pdf

entry for criminal property – particularly proceeds of drug trafficking – is consequently a useful point of comparison with regard to its AML Laws.

1.2.4.1 Spain Review

Spain has set a good example ¹¹⁸ for many countries.¹¹⁹ As an economy with a very strong export industry as well as key entry ports into Europe,¹²⁰ Spain is more exposed than most to Trade Based Money Laundering. The FATF report in 2014 ¹²¹ stated “*Spain has sound AML/CFT institutions*” and “*Spain has a high level of understanding of its ML/TF risks*”, a positive and glowing review of Spain’s AML/CFT system, offset somewhat by other reports that state the problems faced by Spain in relation to ML activity and CDD processes.¹²²

¹¹⁸ The evidence to support the comments on Spain are found in the opening statement of the FATF publication of 2014 whereby it is stated "In general Spain has a strong system of supervision. Spain has a single supervisor (SEPBLAC) responsible for AML/CFT supervision of the financial sector, in cooperation with sector prudential supervisors...SEPBLAC's approach to risk analysis is comprehensive." FATF (2014), "Supervision" in Anti-money laundering and counter-terrorist financing measures - Spain, Fourth Round Mutual Evaluation Report, FATF. www.fatf-gafi.org/topics/mutualevaluations/documents/mer-spain-2014.html "The FATF found Spain has up-to-date laws and regulations and sound institutions for combatting such threats, in particular a strong financial intelligence unit. There have been significant successes in investigating and prosecuting money laundering but the terms of imprisonment imposed are low, the report said." And "The President of the FATF, Roger Wilkins, said "We congratulate Spain on the progress it has made since its 2006 Evaluation. The Spanish government has made great efforts to update its laws and institutions to deal with money laundering and terrorist financing. This FATF evaluation recognises that, overall, their approach is working. But of course, there is always more to do, and the FATF has highlighted a number of priority actions for Spain to take." OECD. (2014)

"Spain has strong measures to combat money laundering and terrorist financing but improvements needed, says FATF". Organisation for Economic Co-operation and Development, Paris, France. Available at: <https://www.oecd.org/spain/spain-has-strong-measures-to-combat-money-laundering-and-terrorist-financing-but-improvements-needed.htm>

¹¹⁹ Trulioo. (2015). "Spain's Strong Compliance Regime a Model for Others to Follow". Trulioo. Available at: <https://www.trulioo.com/blog/spains-strong-compliance-regime-a-model-for-others-to-follow/>

¹²⁰ Grande, M.J.G. and Morales, J.M.L., 2015. The Agri-Food trade in Spain: specialization and international competition.

¹²¹ FATF (2014). "Spain's measures to combat money laundering and terrorist financing". FATF, Paris, France Available at: www.fatf-gafi.org/countries/s-t/spain/documents/mer-spain-2014.html

¹²² Harvey, J., 2015. A Critical and practical evaluation of the efficacy and cost benefit of anti-money laundering laws. Vancouver

1.2.4.2 Malaysia Review

Malaysia's AML/CFT system is seen to be in line with international guidelines and the nation can proficiently counter such activities– a result of the state forming the National Coordination Committee (NCC) in 2000.¹²³ The FATF report in 2015¹²⁴ stated: “Malaysia’s legal framework for supervision is sound and all regulators apply a risk-based approach to supervision”. The report continued, “The regulatory framework for preventative measures is highly compliant, which sets a good starting point” and further stated, “Malaysia’s robust policy framework for AML/CFT reflects strong political commitment and well-functioning coordination structures for AML/CFT and combating proliferation financing.” The report portrayed an overall positive reflection of the efforts of the Malaysian government in addressing global risks and concerns of AML. However, the 1MDB scandal in 2016¹²⁵ shocked the country, opening up a great deal of public outcry,¹²⁶ which ultimately led to the firing of the deputy prime minister, and a review of the country’s financial crime policies.¹²⁷

¹²³ NCC is an independent body which consists of 16 ministries and government agencies. The NCC is led by the Financial Intelligence Unit (FIU), a unit in Bank Negara Malaysia (BNM).

Nazri, S.N.F.S.M., Zolkafli, S. and Omar, N., 2016. The Effectiveness of the Law Enforcement Agencies in Investigating Money Laundering Cases: An Evaluation of Mutual Evaluation Report of Malaysia and Australia.

¹²⁴ FATF and APG (2015), Anti-money laundering and counter-terrorist ... Malaysia, Fourth Round Mutual Evaluation Report, FATF, Paris and APG www.amlcft.bnm.gov.my/document/Mutual-Evaluation-Report-Malaysia-2015.pdf

¹²⁵ Wright, T. and Brown, K., 2015. Malaysia’s 1MDB Scandal: Political Intrigue, Billions Missing and International Scrutiny. Wall Street Journal

¹²⁶ Saleem, S. and Han, D.G.X., 2015. 1MDB and Consolidation of Power: Challenges to the Najib-led Government.

¹²⁷ Ng, J., 2015. Malaysia’s Najib Razak Fires Deputy Prime Minister in 1MDB Rift. The Wall Street Journal, 28

1.2.4.3 Australia Review

Australia, one of the first nations among the OECD to form a financial intelligence Unit (FIU) ¹²⁸ had its anti-money laundering legal system receive an FATF endorsement.¹²⁹ The Mutual Evaluation Report of 2015 ¹³⁰ issued by the FATF stated “Operationally, national AML/CTF coordination is very comprehensive” and “...Australia’s legal framework to combat TF is comprehensive” further stating “Australia’s legal framework to implement targeted financial sanctions is a good example for other countries.” The FATF and GAFI went on to say, “The Mutual Evaluation Report of Australia recognises that Australia has a good understanding of its money laundering risks, coordinates domestically to address these risks, and has highly effective mechanisms for international cooperation. However, the authorities focus more on the disruption of predicate crimes, rather than on the laundering of the proceeds of these crimes and their confiscation. Therefore, while the report recognises that Australia develops good quality financial intelligence which it shares with law enforcement bodies and other authorities, the report concludes that this information should lead to more ML/TF investigations.”¹³¹

¹²⁸ Sathye, M., & Patel, C. (2007). Developing Financial Intelligence: An Assessment of the FIUs in Australia and India. *Journal of Money Laundering Control*, 10(4), 391–405

¹²⁹ Rubinfeld, Samuel. (2015) "FATF Endorses Belgium, Australian AML Legal Systems". *The Wall Street Journal*. Available at : blogs.wsj.com/riskandcompliance/2015/04/24/fatf-endorses-belgium-australian-aml-legal-systems/

¹³⁰ FATF and APG (2015), Anti-money laundering and counter-terrorist financing measures - Australia, Fourth Round Mutual Evaluation Report, FATF, Paris and APG, Sydney www.fatf-gafi.org/topics/mutualevaluations/documents/mer-australia-2015.html

¹³¹ FATF. (2015). "Australia has a mature regime for combating money laundering and terrorist financing, but certain key areas remain unaddressed, says FATF". FATF, Paris, France. Available at: www.fatf-gafi.org/documents/documents/australia-mature-regime-to-combat-money-laundering-terrorist-financing-key-areas-remain-unaddressed.html

It should be noted that despite the positive inclination of the reports, countries within the FATF system still endure mass breaches of their AML activity. The very same report ¹³² on Australia also found that its legislative regime was not meeting the FATFs global standards. The organisation Transparency International released a document highlighting flaws in the Australian system. The report ¹³³ stated, *“The current AUSTRAC method of regulation is analogous to the approach taken in the United Kingdom (UK) which resulted in a significant portion of UK banks being unwilling to turn away profitable business relationships even when there appeared to be an unacceptable risk of handling the proceeds of crime”*.

1.2.4.4 International Growth Phase

It is clear from our initial exploration of the UK AML procedures and institutions, and the subsequent quick review of other countries that AML is still in an organic phase of growth, countries have to grapple with quickly changing criminal and technological environments and very often the private sector is less than enthusiastic about incorporating additional regulation and administration. It is tempting to ask the question, are all these efforts not being duplicated, could the lessons learned by the UK, in the above examples with regards to for instance separate confiscation

¹³² Transparency International. (2015). "What does a billion dollars of illicit funds from China say about Australia's anti-money laundering systems?". Transparency International, London, UK. Available at: transparency.org.au/wp-content/uploads/2015/02/Illicit-funds-from-China-Australias-AML-system.pdf

¹³³ Transparency International. (2015). "What does a billion dollars of illicit funds from China say about Australia's anti-money laundering systems?". Transparency International, London, UK. Available at: transparency.org.au/wp-content/uploads/2015/02/Illicit-funds-from-China-Australias-AML-system.pdf

courts be immediately replicated by other countries, who need not necessarily learn that lesson the hard way.

It is, or should be, the FATF's task to coordinate this reporting, making lessons learned as well as institutional or procedural successes available to members in a way that helps younger members avoid replicating mistakes made. However, of preeminent consideration are the inherent differences in the AML realities of different countries, making it unlikely that one-size-fits all approach will soon be developed.

1.2.5 Sovereignty

Sovereignty is a nation state's absolute right to self-rule, free from outside influence and answerable to no higher power.¹³⁴ Impinging on a nation's sovereignty by attempting to control parts of its territory, people or resources is essentially an act of war. As an increasingly global community, however, the concept of sovereignty is changing.¹³⁵ Human rights treaties, and to some lesser extent climate change treaties, are examples of the global community reserving the right to interfere in the internal actions of a sovereign state.¹³⁶ Anti-money laundering and trade-based money laundering in particular are swiftly becoming global issues, requiring close co-operation between nations. However, membership, participation, reporting and information sharing on platforms such as the

¹³⁴ Definition retrieved from <http://www.businessdictionary.com/definition/sovereignty.html>

¹³⁵ Agnew, J., 2009. Globalization and sovereignty. Rowman & Littlefield Publishers.

¹³⁶ Globalization 101, The Issue of Sovereignty Retrieved from <http://www.globalization101.org/the-issue-of-sovereignty/>

FATF and its associate organizations is entirely voluntary; FATF regulations are effectively only suggestions, and are in no way enforceable. Sovereignty also means that corrupt regimes, where much criminal money originates, are entirely disinclined to participate,¹³⁷ perpetuating the problem.

1.2.5.1 Critical Challenges to AML Enforcement.

Money laundering and trade based money laundering are global crimes with no attention to borders; successfully tackling them requires an international effort. This is hampered at times by issues not solely restricted to the issue of sovereignty. A corollary of sovereignty is the fact that, by definition, national security apparatus is designed to maintain and enforce the law within a national boundary, TBML and most other ML transactions are cross-border by nature, requiring strong communication and agreement between countries:

“by definition, transnational crime crosses borders. But the law enforcement institutions that have developed over centuries were constructed to maintain order primarily within national boundaries.”¹³⁸

The finer details of criminality – in other words whether both countries involved in the transaction necessarily agree that a crime has in

¹³⁷ Reno, W., 2001. How sovereignty matters: international markets and the political economy of local politics in weak states. Intervention and transnationalism in Africa: global-local networks of power, pp.197-215.

¹³⁸ The Global Regime for Transnational Crime" www.cfr.org/transnational-crime/global-regime-transnational-crime/p28656

fact been committed – is a further complication, and speaks to how well-written and enforced the AML laws are:

*“the requirement of dual criminality, whereby assistance is only possible if the alleged offense violates both countries' law.”*¹³⁹

Should both countries agree on the definitions of ML crimes, and have sufficient law enforcement resources, it is additionally necessary that bi-lateral communication be of a very high calibre. Tracking and updating information on the nature and details of ongoing investigations with other enforcement agencies leads to greater rates of detection and prosecution. Naturally, the more widely spread information is, the more unsecure it becomes, making trust and co-ordination in these instances of high importance:

*“The delegate of Tanzania hailed the cooperation of the partners of the Southern African Development Community (SADC), which had adopted programmes for information exchange to combat money laundering.”*¹⁴⁰

A further complication in this regard is that law enforcement agencies are famously unwilling to surrender hard-won data and information with regards to ongoing investigations, furthermore that information is often also politicized, making it even less likely to be shared with other countries:

¹³⁹ Carrielyn Donigan Guymon, International Legal Mechanisms for Combating Transnational Organized Crime: The Need for a Multilateral Convention, 18 Berkeley J. Int'l Law. 53 (2000). Available at: <http://scholarship.law.berkeley.edu/bjil/vol18/iss1/2>

¹⁴⁰ GENERAL ASSEMBLY THIRD COMMITTEE 11th Meeting (PM) GA/SHC/3635 16 OCTOBER 2001 www.un.org/press/en/2001/gashc3635.doc.htm

*" the international community requires solid data to gauge the challenge and effectiveness of responses, but data on transnational organized crime is notoriously difficult to gather and is often politicized."*¹⁴¹

Transnational AML enforcement is further complicated when involving developing countries. Here judicial systems are still in a phase of development, and also respond relatively slowly, as such AML laws are seldom at an advanced stage by comparison to developed countries.¹⁴²

No matter how developed enforcement and legal systems are, FIUs seeking to retain a measure of control over their ML risk, need to dedicate significant resources to retain up-to-date contact and cooperation with partner FIUs in other countries:

"AUSTRAC has taken the initiative to set up regulatory overseas contacts with the FIUs of Canada and New Zealand."¹⁴³

A further list of 5 critical challenges to AML enforcement, from the academic perspective of Verdugo-Yepes are:

"1. The lack of a universal criminalization of money laundering and the financing of terrorism according to UN instruments.

¹⁴¹ The Global Regime for Transnational Crime" www.cfr.org/transnational-crime/global-regime-transnational-crime/p28656

¹⁴² Avi-Yonah, Reuven S. "Globalization, Law and Development: Introduction and Overview (Globalization, Law and Development Conference)." M. S. Barr, co-author. Mich. J. Int'l L. 26, no. 1 (2004): 1-12.

¹⁴³ FATF and APG (2015), "International cooperation" in Anti-money laundering and counterterrorist financing measures - Australia, Fourth Round Mutual Evaluation Report, FATF, Paris and APG, Sydney www.fatf-gafi.org/topics/mutualevaluations/documents/mer-australia-2015.html

2. *The existence of financial institutions with secrecy laws in some jurisdictions, acting as a hindrance for the effectiveness of the AML/CFT strategy.*
3. *Even if the existence of an effective national Financial Intelligence Unit (FIU) may help the effectiveness of the AML/CFT implementation, this is not operational in some countries, or if it is, it is sometimes unable to exercise its role due to a lack of effective power.*
4. *Some domestic Anti Money-Laundering and the Combating of Terrorist Financing Regimes have failed to provide the mutual legal assistance and assistance for carrying out law enforcement action if necessary, as well as to enhance information sharing and cooperation across borders.*
5. *The financial regulators of banking, insurance and securities have a lack of authority to investigate, limited access to time-sensitive data needed for surveillance purposes, insufficient resources for inspection, surveillance and investigation, and often a limited enforcement mandate.*¹⁴⁴

1.2.5.2 FATF Challenges in Developing Countries

¹⁴⁴ Verdugo-Yepes, C., 2008. Enhancing international cooperation in the fight against the financing of terrorism. *Journal of Global Change and Governance*, 1(3), pp.1-27

The FATF as a task team convened by a set of core member countries, has formalised good AML practice, as a useful measure for AML compliance, and a helpful knowledge base for developing countries hoping to improve their AML laws. However, the FATF is in no way responsible for either the development of country-specific policies, nor does it enforce AML regulation within countries. These tasks fall to policy makers and whatever Financial Intelligence Unit (FIU) the country has in place. With particular regard to developing countries, there is often a lack of internal capacity, technology, budget, training and in some instances, political will to reform internal banking systems in line with the FATF's regulations. Additionally, the judiciary as well as border control systems and policies are underdeveloped, and lack sufficient training to mitigate ML.

“The FATF approach is highly data-driven. The FIU is expected to have the capacity to store and efficiently analyze huge amounts of diverse data. The fact that developing country FIUs often lack this budget and staff technical capacity contributes to such countries being rated as non-compliant with the relevant FATF standards. Moreover, it is not just an issue with FIU capacity. Many developing countries lack sufficient training of police or border patrol. Judges and prosecutors regularly have too little experience or specialized knowledge to handle the complexities of a money laundering or terrorist financing case. All of these are

*commonly raised issues in developing country FATF assessments.”*¹⁴⁵

1.2.6 AML Regulation

The banking regulation sector is responsible for monitoring the mechanisms and effectiveness of AML systems, which in turn are responsible for detecting and reporting suspicious activities within banks. However, the increased regulation, along with the training and recruitment of staff to implement the financial control mechanisms, also has a significant cost impact on the banking industry. It is estimated that for Anti-Money Laundering (AML) regulation alone it costs the banking sector in the region of \$5.8 billion for 2014.¹⁴⁶ This places banks in a dilemma since they ultimately have to operate as a viable business and AML controls are sometimes viewed as beyond the scope of the main banking business.¹⁴⁷ Since some banks may have been viewed as showing reluctance to engage with the regulation approach this has caused regulators to harden their position and introduce legal cases and fines as a way of instilling a culture of AML compliance, although this has been criticised as an ineffective long term approach.¹⁴⁸ One of the advantages of legal cases is that they provide an opportunity for academics and industry experts to

¹⁴⁵ Zerzan, Andrew (2011) Policing Financial Services: Surveying the Anti-Money Laundering Regulatory Regime (Bill and Melinda Gates Foundation), pp.21-22.

¹⁴⁶ Neilsen, G., & Fumeaux, W. (2013). Financial crime: Compliance and failure. Retrieved from <http://www.bankingtech.com/57881/financial-crime-compliance-and-failure>

¹⁴⁷ FSA. (2011). Financial Crime Newsletter. FSA

¹⁴⁸ Pellegrina, L. D., & Masciandaro, D. (2008). The Risk Based Approach in the new European Anti-Money Laundering Legislation: A Law and Economics View. "Paolo Baffi" Centre Research Paper Series No. 2008-22, 1-24.

examine some of the underlying issues within the sector and to provide alternative solutions to the problem. This research uses one such case study produced through the Permanent Subcommittee on Investigations in the US, it examines the situation at HBUS where a number of AML breaches were reported by the regulator against the HSBC bank.

Case studies provide one source of information relating to what happens in a banking context. Another option that was used in this research was to engage with officials working on AML compliance across the financial services sector. The role of reporting suspicious AML related transactions or activity is usually designated to a particular unit within the bank, often supported by a money laundering reporting officer (MLRO). In the data section of this research the respondents were selected from across these and/or similar positions and also asked which other areas of the bank should be involved in money laundering and TBML detection. In particular, the research was interested in the relationship between the internal audit function and AML compliance, and whether this was a resource that was utilised fully within the banking sector. This link was chosen because a number of industry papers ¹⁴⁹ had suggested that internal audit should play a greater role in AML compliance processes. In addition to internal audit there were a number of other links that the research wanted to explore, including the role of governance and the impact of technology on AML regulation and compliance.

¹⁴⁹ PWC. (2014). Internal audit holding the line on BSA/AML compliance.

Hermanson, D. R. (2002). The growing stature of internal auditing. *Internal Auditing*, 17(6), 43.

Pickett, S. (2000). Developing internal audit competencies. *Managerial Auditing Journal*, 15(6), 264-265.

The development, issuance and enforcement of AML banking regulations have been of great focus. It is however helpful to briefly explore how these banking regulations in general are issued, and enforced. This will give context to the challenges of AML enforcement.

The global banking system, when viewed as individual country-based systems, is governed by thousands of laws emanating from national and local regulators,¹⁵⁰ not to mention the global regulations (firm suggestions rather than enforceable laws) issued by inter-governmental organisations such as the FATF. Over time, the banking sector has become increasingly regulated,¹⁵¹ usually because of successive systemic failures: the most recent being the sub-prime meltdown of 2006/7.

Regulation is developed across a number of vectors: ownership, capitalisation, deposit guarantees, credit regulations and foreign ownership to name a few. It is, however, dramatically easier to write a law, than to enforce it. Some countries, like the USA, have five distinct financial regulation enforcement agencies¹⁵² whilst others, such as Zimbabwe, make do with only one. In Zimbabwe's case, it is the Reserve Bank

¹⁵⁰ Srinivas.V et al. 2015. 'Enforcement actions in the banking industry trends and lessons learned' [web article] Deloitte Press. Mumbai. Retrieved from: <https://dupress.deloitte.com/dup-us-en/industry/banking-securities/bank-enforcement-actions-trends-in-banking-industry.html> (Accessed on 22 February 2017)

Anon. 2009. CORPORATE GOVERNANCE IN AFRICA CASE STUDY SERIES: NO 6 To study the effectiveness of legal corporate governance mechanisms that exist to protect shareholders of multinational companies operating in Zimbabwe. Unit for Corporate Governance in Africa, p 3, Retrieved from: http://www.usb.ac.za/governance/Documents/pdfs/No.6_Zimbabwe_case%20study%202009.pdf

¹⁵¹ FDIC, "FDIC enforcement decisions and orders," <https://www5.fdic.gov/EDO/>

Kapstein, E.B., 1989. Resolving the regulator's dilemma: international coordination of banking regulations. *International Organization*, 43(02), pp.323-347

¹⁵² Srinivas.V et al. 2015. 'Enforcement actions in the banking industry trends and lessons learned' [web article] Deloitte Press. Mumbai. Retrieved from: <https://dupress.deloitte.com/dup-us-en/industry/banking-securities/bank-enforcement-actions-trends-in-banking-industry.html> (Accessed on 22 February 2017)

itself.¹⁵³ The near collapse of the Zimbabwe banking sector in 2004, whilst occurring against a backdrop of severe lack of investor confidence, can be traced back to an under resourced enforcement agency.¹⁵⁴

Whilst many banks are complicit in breaking regulations¹⁵⁵ a lack of enforcement in part or full is also to blame.¹⁵⁶ Regulations are only as powerful as a regulator's ability to enforce them.¹⁵⁷ Very often training, resources and budget are labelled as the primary reasons for why enforcement fails.¹⁵⁸ This illustrates that not only is the development of regulation crucial, but political will and funding is essential to truly effective enforcement.¹⁵⁹

This brief discussion on the limitations of banking regulation enforcement reminds us that AML and TBML regulation and enforcement has to succeed within these contexts and challenges, with the added difficulty of being applied consistently across national borders.

¹⁵³Anon. 2009.CORPORATE GOVERNANCE IN AFRICA CASE STUDY SERIES: NO 6To study the effectiveness of legal corporate governance mechanisms that exist to protect shareholders of multinational companies operating in Zimbabwe. Unit for Corporate Governance in Africa, p 3, Retrieved from: http://www.usb.ac.za/governance/Documents/pdfs/No.6_Zimbabwe_case%20study%202009.pdf

¹⁵⁴ Ibid.

¹⁵⁵Clouse. M 2016 Wells Fargo Scandal Shows Lack of Regulation Enforcement [web article] Retrieved from: <http://news.du.edu/wells-fargo-scandal-shows-lack-of-regulation-enforcement> (Accessed on: 22 February 2017)

¹⁵⁶ NielWillardson and Jackie Brunmeier, "Supervisory enforcement actions since FIRREA and FDICIA," Region, Federal Reserve Bank of Minneapolis, September 1, 2006, <https://www.minneapolisfed.org/publications/the-region/supervisory-enforcement-actions-since-firrea-and-fdicia>

¹⁵⁷Timothy J. Curry, John P. O.Keefe, Jane Coburn, and Lynne Montgomery, Financially distressed banks: How effective are enforcement actions in the supervision process?, FDIC, September 24, 1999, p. 1, https://www.fdic.gov/bank/analytical/banking/1999oct/1_v12n2.pdf

Sutinen, J.G. and Kuperan, K., 1999. A socio-economic theory of regulatory compliance. International journal of social economics, 26(1/2/3), pp.174-193.

¹⁵⁸ Vaithilingam, S. and Nair, M., 2009. Mapping global money laundering trends: Lessons from the pace setters. Research in International Business and Finance, 23(1), pp.18-30

¹⁵⁹Timothy J. Curry, John P. O.Keefe, Jane Coburn, and Lynne Montgomery, Financially distressed banks: How effective are enforcement actions in the supervision process?, FDIC, September 24, 1999, p. 1, https://www.fdic.gov/bank/analytical/banking/1999oct/1_v12n2.pdf

1.3 Governance

Ultimately within the banking structure managing the overall assessment and detection of money laundering activity is the responsibility of the directors, although they are very dependent on the quality of information being provided to them through the management and auditing structures. For example, weaknesses in this structure have been noted in the past through cases such as HBUS.¹⁶⁰ As part of the governance structure, the internal audit function (IAF) is considered to be one of the four pillars of banking governance; along with the audit committee, board of management and the external auditors. However, although internal audit is part of that governance structure, the internal audit role should ideally be used to check on the extent to which policies have been carried out and applied rather than as a tool of management.¹⁶¹ Instead its role has been considered by some academics to have been side-lined from debates, especially since the financial crisis of 2007.¹⁶² This research explores whether TBML auditing and TBML compliance are different issues for governance and what should be the difference between the two areas.

¹⁶⁰ Homeland Security. (2012). HSBC exposed US financial system to money laundering, drug, terrorist financing risks. From permanent sub committee on investigations. US Senate.

¹⁶¹ Bazley, S. and Haynes, A., 2006. Financial Services Authority Regulation and Risk-based Compliance (2nd rev. Tottel Publishing.

Naheem, M.A., 2016. Internal audit function and AML compliance: the globalisation of the internal audit function. *Journal of Money Laundering Control*, 19(4), pp.459-469.

¹⁶² Lenz, R., & Sarens, G. (2012). Reflections on the internal auditing profession: What might have gone wrong? *Managerial Auditing Journal*, 27(6), 532-549. doi:10.1108/0268690121123638

1.3.1 Ethical Behaviour

The trust placed in banks is contingent on a constant and unassailable ethical standard evident at every level of a bank's operations. This naturally includes the behaviour and personal moral framework of individual employees, which becomes another area one needs to consider when studying the money laundering risks faced by banks.¹⁶³ The risk that an employee will “go rogue” has existed ¹⁶⁴ ever since we began entrusting others with our money.¹⁶⁵

In the context of this category of research, bank insiders can perform a range of functions on behalf of criminals. This type of insider complicity often plays a role in money laundering and trade-based money laundering.¹⁶⁶ Bank employees, as with most human beings, are fallible and can be bribed, coerced or blackmailed into assisting criminals.

“It is estimated that there are between 2000 and 3000 compromised employees working within the UK’s top 500 banks. Criminals start the relationship, usually, by asking a low- rung employee to bend the rules slightly, they then go to

¹⁶³Green, C.F., 1989. Business ethics in banking. Journal of Business Ethics, 8(8), pp.631-634.

¹⁶⁴Pinal, Stanley. (2009) Rogue traders who went off the rails. The Financial Times Ltd. Available at: <https://www.ft.com/content/2d78785c-e755-11dd-aef2-0000779fd2ac>

¹⁶⁵Cohn, A., Fehr, E. and Maréchal, M.A., 2014. Business culture and dishonesty in the banking industry. Nature, 516(7529), pp.86-89.

¹⁶⁶Alexander, Richard (2003) 'Criminal liability of employees of financial intermediaries for money laundering: a British perspective.' Retrieval from https://eprints.soas.ac.uk/75/1/Mikolajki_2002.pdf

use evidence of the first corruption to blackmail employees into conducting more serious offences.”¹⁶⁷

A lack of ethics need not always be why employees overlook suspicious transactions, a lack of training, insight or competency can also lead to an SAR not being submitted, as can the employees preference to not endure a burdensome process of ‘paperwork’. As we have discussed earlier,¹⁶⁸ certain bank employees have some measure of discretion when it comes to identifying suspicious banking activity or transactions. Simply not filing a suspicious activity report (SAR) with the authorities can ensure that cases of money laundering go undetected.¹⁶⁹ Bank employees also have insider information that could be exploited by money launderers. We can therefore safely conclude that not only are a bank’s employees a key factor in determining a bank’s exposure to money laundering and trade based money laundering, but also by its nature, this type of risk is harder to detect. The HSBC case study, discussed later in the thesis, allows one to understand the magnitude of such behaviour.

1.3.1.1 Beyond the Ethics of Bank Employees

¹⁶⁷ Murray-West, Rosie. (2004), "Fraud-finder general rides in by taxi". The Telegraph, Telegraph Media Group Limited, United Kingdom. Available at : www.telegraph.co.uk/finance/2894020/Fraud-finder-general-rides-in-by-taxi.html

¹⁶⁸ (e.g. definitions of suspicion in the introductory chapter)

¹⁶⁹ Reuter, P., & Truman, E. M. (2004). Chasing dirty money: The fight against money laundering. Washington, DC: Institute for International Economics

Global Witness. (2009) How banks do business with corrupt regimes - Retrieved from https://www.globalwitness.org/documents/14621/undue_diligence_lowres.pdf

Childress, John R. (2015) The Challenge of Managing Ethical Behaviour in Banking Available at: www.ftiecla.com/wp-content/uploads/2015/09/Banking_Behaviour_change_v4.pdf

Belas, Jaroslav. Social responsibility and ethics in the banking business: Myth or reality? (2012) ECONOMIC ANNALS, Volume LVII, No. 195 / October – December 2012 UDC: 3.33 ISSN: 0013-3264

It is of course possible and in many countries probable, that banking fraud and money laundering is facilitated by those in power. Corrupt regimes and governments are bolstered, and in some cases consist entirely of dense criminal networks that operate within the highest echelons of government ¹⁷⁰. In these circumstances, even the most honest and ethical of bank employees would be hard-pressed to question the transactions of a political elite:

*“Businessmen involved in these different activities are linked together in criminal networks, and also linked to powerful figures in the bureaucracy, police, military and politics. Some cabinet members in recent governments have been implicated in various illegal activities.”*¹⁷¹

It must also be noted that organized crime, and by extension the laundering of large amounts of money, would in no way be possible without the complicity of a number of high ranking officials and professionals,¹⁷² stressing its links with the upper world by highlighting the *“indispensable functions for professional criminals played by “certain specialized persons or groups,” including doctors, lawyers, politicians, and corrupt officials.”*¹⁷³

¹⁷⁰ It is not Anti-Money Laundering legislation that alone can tackle money laundering but rigid enforcement procedures on banks and finance houses, good governance from central banks and how international cooperation may be developed to combat these crimes. The issue of corruption, particularly in the upper echelon of public officials should receive some attention in this effort.

¹⁷¹ Phongpaichit, P., Guns, G. and Gambling, C.J., 1999, November. Thailand's Illegal Economy and Public Policy. In Seminar paper delivered at the Centre of Southeast Asian Studies, Kyoto University (p. 57).

¹⁷² Ibid

¹⁷³ Paoli, L. ed., 2014. The Oxford handbook of organized crime. Oxford Handbooks.

1.3.2 Evolving Risk

Assessing risk is an essential function for the financial sector, particularly in its aims of preventing money laundering and trade based money laundering. It also remains one of the most complex strategic requirements, particularly because meaningful risk assessment needs to be almost by-the-minute analysis of fast-changing realities, with practically no end in sight.¹⁷⁴ The constantly changing environment ¹⁷⁵ e.g. legislative, technological, economic and political, in which banks operate means their risk assessments must constantly evolve and adapt.¹⁷⁶ The fast pace of change itself is a risk, as criminals become ever more sophisticated in their use of new technologies.¹⁷⁷

Banks must assume that with each new technological change, be it a new device, virus, or software update comes a correlated risk that their systems will not adapt as quickly as a criminal's ability to exploit those changes.¹⁷⁸ Additionally, with every step taken ¹⁷⁹ to narrow, or eliminate, a bank's money-laundering risk through technology investment, procedural changes or improved detection and punishment of money laundering,

¹⁷⁴ Humphrey, C. and Lim, C.Y., The Never-Ending Appeal of Risk Management: An Alternative Research Agenda. Available at: https://fp7.portals.mbs.ac.uk/Portals/59/docs/MC%20deliverables/WP1_2%20CY%20Lim%20working%20paper3_holisticRM.pdf

¹⁷⁵ Smith, D. & Fischbacher, M. Risk Manag (2009) The changing nature of risk and risk management: The challenge of borders, uncertainty and resilience. 11: 1. doi:10.1057/rm.2009.1

¹⁷⁶ Carroll, T., 2010. A Holistic Approach to Business Risk Management. Approaches to Enterprise Risk Management.

¹⁷⁷ Juan, Tan. (2016) Risk Assessment of Computer Network Security in Banks. International Journal of Security and Its Applications Vol. 10, No. 4 (2016), pp.1-10 <http://dx.doi.org/10.14257/ijisia.2016.10.4.01> Available at www.sersc.org/journals/IJSIA/vol10_no4_2016/1.pdf

¹⁷⁸ Poveda, Raimundo. (2016) Banking Regulation, A Never-Ending Story available at: www.thecorner.eu/world-economy/banking-regulation-a-never-ending-story/50461/

¹⁷⁹ Bessis, J., 2011. Risk management in banking. John Wiley & Sons.

criminals are conducting their own risk assessments,¹⁸⁰ and evolving in tandem.¹⁸¹ This is especially pertinent when considering the discussion above and the role insiders can play in a bank's overall risk profile. Criminals have a natural incentive to uncover new and ingenious ways to defeat existing risk policies;¹⁸² it is, in effect, a battle doomed to rage on.¹⁸³

1.3.3 Internal Audit

Internal audit function (IAF) is not normally seen as the lead player in the detection of money laundering activity within banks. However, as the global rise in money laundering activity continues it is likely that a revised approach to AML risk management is needed, and within that a different function for internal audit might need to be considered as well. The financial conduct authority in the UK ¹⁸⁴ highlighted weaknesses in internal audit involvement in AML compliance, and stated that from their findings auditors tended to focus *"on whether processes had been followed rather than whether reasonable judgements had been made by relevant staff."*¹⁸⁵

¹⁸⁰ Danisch, R., 2013. Risk assessment as rhetorical practice: The ironic mathematics behind terrorism, banking, and public policy. *Public Understanding of Science*, 22(2), pp.236-251.

¹⁸¹ Williams, B.J., Carver, J. and Vaughn, R.B., 2006. Change Risk Assessment: Understanding Risks Involved in Changing Software Requirements. In *Software Engineering Research and Practice* (pp. 966-971).

¹⁸² Mehran, Hamid, *Introduction and Appendix to Behavioral Risk Management in the Financial Services Industry: The Role of Culture, Governance, and Financial Reporting* (2016). *Economic Policy Review*, Issue Aug, pp. 1-2, 2016. Available at SSRN: <https://ssrn.com/abstract=2828080>

¹⁸³ Srivastav, S., 2013. A study of enterprise risk Management in banks. *Journal of Management-Gyanpratha-ACCMAN*, 5(1), pp.1-10.

¹⁸⁴ FCA. (2013). *Bank's control of financial crime risks in trade finance*. London: Financial Conduct Authority.

¹⁸⁵ FCA (2013, p33)

This means that auditors need to examine the underlying assumptions made by the company in their AML process, and focus on the relevance of the approach taken and the questions asked of the client. This is especially important since auditors will not usually be in a position to verify individual client transactions especially when using limited sampling approaches. In addition, many of the documents will often appear to be in order and it is not until further investigations or checks are carried out that anomalies will appear. It is also important to remember that this is not a forensic auditor and at this stage the assumption of wrongdoing is not evidenced.

The nature of an Auditor's duty of care in the performance of an audit was considered by Lopes LJ in *Re Kingston Cotton Mills (No 2)* [1896]2Ch 279 at pp 288-9.¹⁸⁶

"It is the duty of an auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful, and cautious auditor would use. What is reasonable skill, care, and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He

¹⁸⁶ *Re Kingston Cotton Mill Company (No.2)* (1896) Lindley L.J., Lopes L.J. and Kay L.J. (Court of Appeal). Available at : [https://en.wikisource.org/wiki/Re_Kingston_Cotton_Mill_Company_\(No.2\)_\(1896\)](https://en.wikisource.org/wiki/Re_Kingston_Cotton_Mill_Company_(No.2)_(1896)).

is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful.”¹⁸⁷

Despite the challenges there is no doubt that continued pressure will be applied to audit companies to recognise potential areas of AML weakness based on evidential outcomes in the audit process and to make recommendations to management to ensure that the bank is adequately protected.¹⁸⁸ This includes analysing the risk of exposure from outside money launderers as well as identifying potential threats from internal rogue traders¹⁸⁹ and those facilitating laundering.

This research aims to explore how the role of IAF could fit into TBML compliance, and to determine how its relationship with the traditional corporate governance structure could be enhanced for this purpose.

¹⁸⁷ Source: http://superfraud.org/?page_id=4784

¹⁸⁸ Eaglesham, J. (2001) 'Auditor's Failure to Detect Leeson Fraud Blamed for Bank's Downfall', Financial Times, 25 October

¹⁸⁹ Greener, Ian. (2006) 'Nick Leeson and the Collapse of Barings Bank: Socio-Technical Networks and the 'Rogue Trader' Organization, vol. 13, 3: pp. 421-441. , First Published May 1, 2006."

1.3.4 Technology

One area that the research is also interested in is the relationship between technology and AML compliance and whether this can facilitate TBML compliance and auditing, or whether these skills are currently not available in the market. One of the challenges, in trying to detect TBML activity, is the complex amount of data that can be generated between all the paperwork including trade documentation, finance details and client information. The research asks the respondents which specific forms of technology and software are used or whether IT is the solution at all for TBML investigations. Another reason for considering a role for IT is to address how criminal organisations have been facilitated in their international money laundering activity, by the banking and technology sectors. It is now possible to quickly and easily move large amounts of money across the globe and avoid detection, or remove the money out of the legal jurisdiction of those seeking to stop the transactions. However, O'Brien and Dixon ¹⁹⁰ (2013) have also highlighted how developments in the global banking sector have created large global structures that are not easily monitored.

“..the recent banking scandals have shown that in each case compliance risk was exacerbated by globalized institutional

¹⁹⁰ O'Brien, J., & Dixon, O. (2013). Common link in failures and scandals at the world's leading banks, the. *Seattle University Law Review*, 19, 941-972

*structures that were too big to manage internally and too big to regulate externally.*¹⁹¹

It is submitted that O'Brien and Dixon's point is particularly relevant to the trading finance sector. Even if individual banks are not as large and many trade banks might be considerably smaller, the global scale of shipping and international finance transfers means that millions of transactions are taking place across the globe involving thousands of air and shipping ports. The scale and speed of how trade finance operates means that even a dedicated team of trade finance analysts within a bank would not necessarily pick up on all the anomalies or red flag indicators. The capacity of banks therefore, regardless of their size, is currently limited in terms of trade finance laundering and that is why it could become the preferred method of money laundering in the future.

There is the need to develop an international response to AML regulation and compliance so that all banks are aware of what is happening in other countries and sharing information across banks can be facilitated easier. The research therefore also considers the future international framework of AML and TBML, and the challenges that banks are likely to face as global money laundering continues to expand.

¹⁹¹ O'Brien & Dixon Common link in failures and scandals at the world's leading banks, the. Seattle University Law Review, 19 (2013, p942)

1.4 Trade Based Money Laundering Research Project

This research project aims to explore the issue of money laundering and the role that banks can play in detecting and reporting it to financial intelligence units across the globe. Since the scale and scope of money laundering activities is quite vast this research will focus on one particular type of money laundering activity, which involves the exploitation and misuse of international trading procedures. This is often referred to as trade based money laundering or TBML,¹⁹² and it involves slightly more complex financial arrangements than traditional cash smuggling and earlier types of money laundering activities. However, since many of the easier techniques for money launderers to enter the financial system are being monitored and assessed by banks, then TBML is increasing in popularity and gaining in sophistication.¹⁹³

1.4.1 Methodology

The research methodology is based upon a pragmatist design¹⁹⁴ and a mixed method approach,¹⁹⁵ which will seek to establish a picture of

¹⁹² FATF. (2006). Trade based money laundering. France. Financial Action Task Force

¹⁹³ Ferwerda, J. (2012). The Multidisciplinary Economics of Money Laundering. Printed by Ridderprint, Ridderkerk, Tjalling C. Koopmans Dissertation Series.

¹⁹⁴ Modell, S. (2009). In defence of triangulation: A critical realist approach to mixed methods research in management accounting. *Management Accounting Research*, 20(3), 208-221. doi: 10.1016/j.mar.2009.04.001

TBML as it applies within the banking sector. Part of the reason for choosing this approach is due to the relatively new definition of (TBML) which is also used in this research, i.e. value (cash, goods or documentation of either) can be moved through a number of banks and across jurisdictions.¹⁹⁶ Many jurisdictions have only recently begun to separate generic money laundering (ML) activity from trade based money laundering (TBML), and so there are only a limited number of reports specifically available on TBML cases, such as the APG report, (2012).¹⁹⁷ This research will use the limited data available and further enhance that information through its own primary data collection, in order to explore the empirical and theoretical challenges of assessing TBML risk within the global banking sector.

In order to establish current thinking from the TBML industry the research uses a modified version of the Delphi approach¹⁹⁸ and includes conducting an online survey¹⁹⁹ with targeted experts that have written or been involved in the subject. The survey covers responses from across the globe and across a number of industries including: banking, financial services, academic, internal audit, AML compliance and regulation. A second stage data collection is then utilised to interview a cross section of the survey respondents, in order to gain more insight and clarity from the perspective of their sector.

¹⁹⁵ Mengshoel. (2012). Mixed methods research - so far easier said than done? *Manual Therapy*, 17, 373-375

¹⁹⁶ FATF. (2006). Trade based money laundering. France. Financial Action Task Force

¹⁹⁷ APG. (2012). APG Typology Report on Trade Based Money Laundering. Sydney: Asia Pacific Group on Money Laundering

¹⁹⁸ Hsu, C. -C., & Sandford, B. A. (2007). The delphi technique: Making sense of consensus. *Practical Assessment, Research & Evaluation*, 12(10)

¹⁹⁹ Dykema, J., Jones, N. R., Piché, T., & Stevenson, J. (2013). Surveying clinicians by web: Current issues in design and administration. *Evaluation & the Health Professions*, 36(3), 352-81

The research uses a mixed method approach²⁰⁰ and supports the primary source findings with a combination of secondary data sources including; a number of industry based financial crime surveys, secondary data from leading industrial reports, case studies and legal reports that are in the public domain, typologies and academic discussions. All of these sources are used to establish a picture of what challenges banks are facing. From this information the project provides a thematic analysis of all the key findings and will use this information to develop an appropriate risk assessment model that could be applied within the banking context.

1.4.2 Justification for the Research

The underlying context for the research is the belief that trade based money laundering is a complex issue that affects all banks involved in international financial transfers. The AML response from banks requires a number of monitoring and regulatory approaches to be adopted, if they are to remain non complicit in supporting this type of criminal activity. Although there are critics of using risk based approaches²⁰¹ because, they suggest, it is too vague. On the other side there is an acknowledgement that following a strict 'rules based' procedures can frequently miss the more complicated ML activities because there is not enough flexibility in

²⁰⁰ Mengshoel. (2012). Mixed methods research - so far easier said than done? *Manual Therapy*, 17, 373-375

²⁰¹ Demetis, D. S., & Angell, I. O. (2007). The risk-based approach to AML: Representation, paradox, and the 3rd directive. *J of Money Laundering Control*, 10(4), 412-428. doi:10.1108/1368520071083090

the risk assessment model.²⁰² Despite the difficulties with the current risk assessment systems, some experts have estimated that the global response to the filing of suspicious reports from financial institutions accounted for 90% of all money laundering investigations²⁰³ highlighting the importance of the system.

Recent findings from the FATF²⁰⁴ have acknowledged that there have been significant gains made towards increased AML monitoring within financial institutions, but they have also noted gaps, especially in detecting the more complex ML schemes such as TBML. This is probably an underestimation of the situation given that many academic reports on countries such as Russia²⁰⁵ and Turkey²⁰⁶ have highlighted the complexities and challenges that the banking sector are currently struggling with in trying to implement standard AML regulation. There has also been a recent spate of whistle-blower reports²⁰⁷ such as the ICIJ reports on Panama²⁰⁸ and HSBC²⁰⁹ in Switzerland, which have indicated that the gaps in implementation are probably significantly higher than FATF²¹⁰ is suggesting.

²⁰² Soudijn, M. (2014). A Critical Approach to Trade-Based Money Laundering. *Journal of Money Laundering Control* Vol 17, Iss 2, 230-242

²⁰³ McCarthy, K. J., van Santen, P., & Fiedler, I. (2014). Modelling the money launderer: Micro theoretical arguments on anti-money laundering policy. *International Review of Law and Economics*. doi: 10.1016/j.irl.2014.04.00

²⁰⁴ FATF Guidance. (2013). *National Money Laundering and Terrorist Financing Risk Assessment*. Paris: Financial Action Task Force.

²⁰⁵ Subbotina, N. (2009). Challenges that Russian banks face implementing the AML regulations. *J of Money Laundering Control*, 12(1), 19-32. doi:10.1108/13685200910922624

²⁰⁶ Yalta, A. Y., & Demir, I. (2010). The extent of trade mis-invoicing in turkey: Did post-1990 policies matter?

²⁰⁷ Francis, R. D., Armstrong, A. F., & Foxley, I. (2015). Whistleblowing: A three-part view. *Journal of Financial Crime*, 22(2), 208-218

²⁰⁸ <https://panamapapers.icij.org/20160403-panama-papers-global-overview.html>

²⁰⁹ <https://www.icij.org/project/swiss-leaks>

²¹⁰ FATF Guidance. (2013). *National Money Laundering and Terrorist Financing Risk Assessment*. Paris: Financial Action Task Force.

Other reports such as the OECD report (2014) ²¹¹ have also discovered that many countries have weak AML systems and information such as client details and beneficial ownership are often missing. This has also been highlighted on a number of occasions recently through leaked documents and investigative journalism reports ²¹² indicating that a thorough understanding of AML procedures is still lacking within many larger international banks. All of these factors will inevitably have a detrimental impact on banks trying to carry out their own risk assessment processes, and the trust that exists between banks if shared BOI and CDD information cannot be verified or accepted.

Part of the aim for this research is to establish what kind of information is required within an adequate and practical risk assessment framework that can be used for the full spectrum of money laundering schemes, or whether that is even possible to achieve.

1.4.3 Research Problem

The current resource and cost implications for banks and financial institutions seeking to implement and maintain AML regulation is quite high. In Germany alone AML compliance has an estimated annual cost of

²¹¹ OECD. (2014). Illicit financial flows from developing countries: Measuring OECD responses. France: OECD

²¹² <https://www.icij.org/project/swiss-leaks>

€775 million.²¹³ The challenge for banks therefore is to develop an AML system that is not too costly or resource intensive; that is flexible in design to cater for all emerging scenarios and which is robust enough to be implemented across all sections and units within the bank.

In order to develop a deeper understanding of some of the specific issues facing banks, involved in ML operational risk assessment, the focus of this research is to explore the issue of money laundering and trade in more depth. This research aims to focus on the different types of money laundering activities that can occur through the misuse of trade operations²¹⁴ as a means of laundering, and to determine how these transactions present and can be detected within a global banking context. From this information the aim is to develop a risk assessment tool that utilises the findings from the data collected.

1.4.4 The Research Context

The research will seek to examine both the current empirical and the theoretical contexts for trade based money laundering. The theoretical model is based upon an Agency theory analysis similar to that applied by a number of authors²¹⁵ looking at TBML related issues. It explores the different types of agency relationship within a money laundering scenario i.e. between bank and client, bank and regulator and clients and

²¹³ McCarthy, K. J., van Santen, P., & Fiedler, I. (2014). Modelling the money launderer: Micro theoretical arguments on anti-money laundering policy. *International Review of Law and Economics*. doi: 10.1016/j.irl.2014.04.00

²¹⁴ Sullivan, C., & Smith, E. (2011). *trade-based money laundering: Risks and regulatory responses*. Canberra: Australian Institute of Criminology.

²¹⁵ (Pellegrina & Masciandaro, 2008; Shah, Shah & Khan, 2006; Macey, 1991)

professional launderers. The theoretical model in this context is therefore important in order to establish the impact of any changes between these various relationships, should the contextual environment alter, e.g. increased regulation.

The empirical context is harder to determine since information on criminal transactions, law enforcement investigations and banking procedures are kept confidential. The research sought to bridge some of this gap by directly surveying current and former banking / financial crime experts within the area of AML, and gaining some direct insight into the challenges that are being faced at a practical level. During the course of the research a number of cases emerged into the public domain and were available to support the research analysis, such as the HBUS case in the US.²¹⁶ In this situation the bank was found to be in breach of five different AML compliance regulations including failing to file STRs, dealing with bulk travellers cheques, and anonymous bond transfers. Cases such as these offer a useful insight into areas of weakness within the banking sector and also highlight how the regulation industry are tackling lack of compliance issues within the industry. Many AML officers obtain their research material from sanitised case study reports such as those made available through individual financial intelligence units within countries, such as FinCEN in the US and AUSTRAC in Australia. The FIUs often produce country specific reports or issue press releases to inform interested parties

²¹⁶ Homeland Security. (2012). HSBC exposed US financial system to money laundering, drug, terrorist financing risks. From permanent sub committee on investigations. US Senate. Retrieved from <http://www.hsgac.senate.gov/subcommittees/investigations/media/hsbc-exposed-us-financial-system-to-money-laundering-drug-terrorist-financing-risks>

of the latest developments and changes in regulatory focus,²¹⁷ which tend to be very generic to avoid legal difficulties but can also offer new insights into trends in money laundering. The main difficulty with these cases is that they are dated because the legal cases have to be cleared before they can publish any information, so banking research is effectively always operating several years behind current trends in money laundering. Other related sector documents such as the OECD report (2014) on addressing illicit financial flows, is another source of information that focuses on related and overlapping issues of laundering and banking interest, such as customer due diligence systems and beneficial ownership information.

The introductory chapter introduces the research context and overview of the problem being explored in this study. The literature review section presents and discusses the main literature relevant to this topic. The methodology chapter covers the research framework including the philosophy, approach, strategy, choices, timeline and data collection based on the research onion model developed by Saunders.²¹⁸ The specific methods chosen for the research included a Delphi approach using an expert panel developed through a series of email communications between leading experts in the field of TBML and ML across both the academic and banking industry sectors.

The data results and the findings chapters both present an overview and analysis of the survey results and the themes that emerged from the

²¹⁷ FinCEN (2014) FinCEN Statement on Providing Banking Services to Money Services Businesses http://www.fincen.gov/news_room/nr/html/20141110.html accessed 27 May 2015

²¹⁸ Saunders, M., Lewis, P., & Thornhill, A. (2007). *Research Methods for Business Students*, (6th ed.) London: Pearson.

semi-structured interviews. These findings are linked into the relevant empirical and theoretical literature. From these findings a proposed risk assessment model is suggested that encapsulates the key learning from the research. The final chapter is the conclusion, which summarises the research findings and links this back to the original research questions and literature results, suggestions are made for future areas of research.

1.4.5 Delimitations of Scope and Key Assumptions

Trade-based money laundering uses a number of techniques that can also be used in other illicit activity such as tax evasion and avoidance of tariffs and shipping costs. This paper does not focus on the other gains except where there is a direct correlation to actual TBML activity linked to money laundering. Many of the AML compliance measures are also used to target terrorist related activities (CTF) which may also include an element of TBML. However, for this research the concern is on using TBML to launder illicit gains rather than transferring legal money for possible future illegal activities.

1.4.6 Conclusion

This research project explores some of the key issues involved in trade-based money laundering (TBML), as it occurs using goods and

services. The main focus of the research is on the role of the banking sector and the possible ways in which these TBML activities can be detected and reported both within the bank and also to the financial crime and intelligence gathering offices across the globe. In order to assess the effectiveness of AML compliance, the role of governance and internal audit are vital components in this process, despite the lack of papers and reports that specify the exact nature of this role. This project aims to highlight the relationship between audit, governance and AML compliance and to discuss a model that applies to all three sectors using a multi-dimensional AML framework. The findings from the research have been applied to the development of a risk assessment framework that can be used within the banking and global financial services sector.

CHAPTER 2 BACKGROUND ISSUES

2 Introduction

This section outlines the background and context to trade based money laundering and the key problems that it brings to the banking sector. The FATF typologies studies indicate that

*“criminal organisations and terrorist groups are exploiting vulnerabilities in the international trade system to move value for illegal purposes. A number of specific money laundering cases were identified which involved the proceeds from various types of predicate offences to include, but not limited to, illicit trafficking in narcotic drugs, illicit trafficking in stolen or other goods, corruption and bribery, fraud, counterfeiting/piracy of products and smuggling. The most basic schemes involve fraudulent trade practices such as: over- and under-invoicing of goods and services, multiple invoicing of goods and services, over- and under-shipments of goods and services, and falsely describing goods and services. More complicated schemes integrate these fraudulent practices into a complex web of transactions and movements of goods. Inherent vulnerabilities in the international trade system, including the enormous volume of trade flows, which obscures individual transactions, provide abundant opportunity for criminal organisations and terrorist groups to transfer value across borders.”*²¹⁹

²¹⁹ FATF.(2008). "Best Practices Paper. Best Practices on Trade Based Money Laundering". FATF and GAFI France: Financial Action Task Force. FATF Guidance Available at : <http://www.fatf->

It also describes how current schemes that have been uncovered have influenced risk assessment approaches within the banking and regulatory sectors.

*“There are three main methods by which criminal organisations and terrorist financiers move money for the purpose of disguising its origins and integrating it into the formal economy. The first is through the use of the financial system; the second involves the physical movement of money (e.g. through the use of cash couriers); and the third is through the physical movement of goods through the trade system.”*²²⁰

In recent years, the Financial Action Task Force has focused considerable attention on the first two of these methods. By comparison, the scope for abuse of the international trade system has received relatively little attention. The international trade system is clearly subject to a wide range of risks and vulnerabilities that can be exploited by criminal organisations and terrorist financiers. In part, these arise from the enormous volume of trade flows, which obscures individual transactions; the complexities associated with the use of multiple foreign exchange transactions

gafi.org/media/fatf/documents/recommendations/BPP%20Trade%20Based%20Money%20Laundering%202012%20COVER.pdf

²²⁰ FATF.(2008). "Best Practices Paper. Best Practices on Trade Based Money Laundering". FATF and GAFI France: Financial Action Task Force. FATF Guidance Available at : <http://www.fatf-gafi.org/media/fatf/documents/recommendations/BPP%20Trade%20Based%20Money%20Laundering%202012%20COVER.pdf>

and diverse trade financing arrangements; the commingling of legitimate and illicit funds; and the limited resources that most customs agencies have available to detect suspicious trade transactions.

For the purpose of this study, trade based money laundering is defined as the process of disguising the proceeds of crime and moving value through the use of trade transactions in an attempt to legitimise their illicit origins. In practice, this can be achieved through the misrepresentation of the price, quantity or quality of imports or exports. Moreover, trade-based money laundering techniques vary in complexity and are frequently used in combination with other money laundering techniques to further obscure the money trail. This study provides a number of case studies that illustrate how the international trade system has been exploited by criminal organisations. It also has made use of a detailed questionnaire to gather information on the current practices of more than thirty countries. This information focuses on the ability of various government agencies to identify suspicious activities related to trade transactions, to share this information with domestic and foreign partner agencies, and to act on this information. The study concludes that trade-based money laundering represents an important channel of criminal activity and, given the growth of world trade, an increasingly important money laundering and terrorist financing vulnerability. Moreover, as the standards applied to other money laundering techniques become increasingly effective, the

use of trade-based money laundering can be expected to become increasingly attractive.”²²¹

2.1.1 Trade Based Money Laundering (TBML)

Money laundering using the trade sector ²²² has been detected within various financial services as far back as the 1960s.²²³ However, it is in more recent years that money laundering has become a more notable area of focus for risk assessment, especially within the global banking sector, as criminals have continued to broaden their scope of activity.²²⁴ Criminals and organised gangs can now exploit nearly all forms of financial services in order to launder the proceeds of their illicit activity,²²⁵ including using documentation and financial services from the trade and shipping sector.²²⁶

Despite the long history of known and established money laundering offences, the diversification into modern trade based options for

²²¹ FATF and GAFI France: Financial Action Task Force. FATF Guidance Available at: <http://www.fatf-gafi.org/publications/methodsandtrends/documents/trade-basedmoneylaundering.html>

²²² APG Typology Report on Trade Based Money Laundering. (2012). Sydney: Asia Pacific Group on Money Laundering

²²³ Mauro, J. S. (2014). THE NEW ECONOMY IN FINANCIAL CRIMES. Understanding the effects of under-invoicing, double invoicing and false invoicing in trade-based money laundering and terrorist financing (TBML & TF) schemes ACAMS.

Buehn, A., & Eichler, S. (2011). Trade misinvoicing: The dark side of world trade. *The World Economy*, 34(8), 1263-1287.

²²⁴ Sullivan, C., & Smith, E. (2011). Trade based money laundering- risks and regulatory responses. Australia: Australian Institute of Criminology. Retrieved from http://aic.gov.au/media_library/publications/rpp/rpp115.pdf

²²⁵ AUSTRAC. (2013). Typologies and case studies report 2013. Australia: AUSTRAC Retrieved from http://www.austrac.gov.au/sites/default/files/documents/typ13_full.pdf

²²⁶ Buehn, A., & Eichler, S. (2011). Trade misinvoicing: The dark side of world trade. *The World Economy*, 34(8), 1263-1287.

laundering is relatively new and this has meant that the definition of TBML is still vague and unclear.²²⁷ Although the name TBML includes the term ‘money laundering’ which implies cash transactions of some kind, in reality it focuses almost exclusively on the falsified use of documents and shipping information to transfer goods and services²²⁸ hence the term trade based. This is highlighted in the FATF definition, which actually doesn’t include the term money or cash at all but instead uses the term value “*the process of disguising the proceeds of crime and moving value through the use of trade transactions in an attempt to legitimise their illegal origins or finance their activities.*”²²⁹ The FATF definition has been criticised for being too vague²³⁰ and in reality most trade based money laundering activities can cover an array of different processes and criminal defrauding activities, as the next few sections will describe.

There has recently been an increased focus on trade-based money laundering (TBML)²³¹ since it has been identified as one of the newest and possibly most complex forms of money laundering to affect the banking and regulatory sectors, across the globe.²³² The rapid expansion of the global trade sector,²³³ along with the increasing development of payment

²²⁷ Soudijn, M. (2014). A Critical Approach to Trade-Based Money Laundering. *Journal of Money Laundering Control* Vol 17, Iss 2, 230-242.

²²⁸ AUSTRAC. (2013). *Typologies and case studies report 2013*.

²²⁹ FATF. (2006). *Trade based money laundering*. France. Financial Action Task Force p5

²³⁰ Soudijn, M. (2014). A Critical Approach to Trade-Based Money Laundering. *Journal of Money Laundering Control* Vol 17, Iss 2, 230-242.

²³¹ Deccan Chronicle. (2014). Government forms panel to check trade-based money laundering. Retrieved from <http://www.deccanchronicle.com/141204/business-latest/article/government-forms-panel-check-trade-based-money-laundering>

²³² Araujo, R. A. (2008). Assessing the efficiency of the anti-money laundering regulation: An incentive-based approach. *Journal of Money Laundering Control*, 11(1), 67-75

²³³ Buehn, A., & Eichler, S. (2011). Trade misinvoicing: The dark side of world trade. *The World Economy*, 34(8), 1263-1287.

APG. (2012). *APG Typology Report on Trade Based Money Laundering*. Sydney: Asia Pacific Group on Money Laundering.

technology, has provided an ideal environment for money launderers to transfer illegally gained money, either in cash or through goods, across the world.²³⁴ It is now recognised that the misuse of the financial trade system is one of the main ways in which criminal gangs move money and integrate it into the formal economy. However, as mentioned earlier it is only part of an overall criminal process and the money may have originated from a variety of criminal activities²³⁵ which are often referred to as predicate offences, including drug and human trafficking, hijacking, piracy and illegal arms dealing.²³⁶ In the past the focus of criminal prosecutions was on the predicate offences only, whereas nowadays money laundering is recognized as a crime in its own right. In addition to the cleansing of dirty money, the transfers may also be used in order to facilitate on criminal activity and terrorist related activities.²³⁷

The main difficulty and challenge for banks dealing with TBML, is that money is often placed into the bank using legitimate businesses as fronts. Criminals then use complex systems of misrepresentation of pricing, invoicing and shipping to merge money gained from criminal activities into legitimate business transactions.²³⁸ In addition, sophisticated money laundering practices such as TBML usually require a partnership between the criminal, who acquires the money, and a professional

²³⁴ Sullivan, C., & Smith, E. (2011). trade-based money laundering: Risks and regulatory responses. Canberra: Australian Institute of Criminology.

²³⁵ FATF. (2012). International standards on combatting money laundering and the financing of terrorism & proliferation [The FATF Recommendations]

²³⁶ Do, Q. -T., Blanc, J., Kruse, A., Le, T., Levchenko, A., Ma, L., Shortland, A. (2013). The pirates of Somalia: Ending the threat, rebuilding a nation. The World Bank Regional Vice-Presidency for Africa

²³⁷ Zdanowicz, J. (2009). Trade Based Money Laundering and Terrorist Financing. Review of Law and Economics Vol 5 No.2, 855-878.

²³⁸ FATF. (2012).

launderer who is often connected or familiar with the financial sector.²³⁹ All of these factors make TBML one of the more difficult techniques to detect, which places an additional stress on the bank's risk assessment strategies and systems. Sanitized case studies might offer some form of support and some of these cases appear in the next section of the review. These examples consider some of these generic typology studies and practical cases. The cases also seek to provide an explanation of the banking methods that were used in the detection of the money laundering activities.

2.1.2 Normal Trading Practices

In order to understand how TBML activity occurs it is first necessary to understand how trade finance operates in legitimate trading transactions. A main trade agreement is made between a buyer who provides payment and the seller who provides the goods. Since most buyers will only pay for goods after or upon receipt the seller needs to raise some form of trade finance in order for the transaction to occur. This is known as pre-shipping finance.²⁴⁰ It is a key role of financial institutions to provide trade finance to the sector and this can be done through a number of means and involves using standard trade documents.

²³⁹ McCarthy, K. J., van Santen, P., & Fiedler, I. (2014). Modelling the money launderer: Micro theoretical arguments on anti-money laundering policy. *International Review of Law and Economics*. doi: 10.1016/j.irl.2014.04.00

²⁴⁰ APG. (2012). *APG Typology Report on Trade Based Money Laundering*. Sydney: Asia Pacific Group on Money Laundering.

All of these systems leave areas of vulnerability for TBML to occur, the message to banks is that fraudulent use of documentation can occur at any of these levels. This is in addition to the reality of collusion between trading parties, which is a necessity for most trade based money laundering to occur.

2.1.3 Using Trade Based Money Laundering

One of the major impacts of money laundering is the transfer of funds from one country to another known as illicit financial flows. This transfer of money from one country to another is often disguised as a genuine business transaction in order to avoid detection. Illicit financial flows account for approximately 3.5-5.7% of GDP across the globe ²⁴¹ although less than 1% of all global illicit trade is actually seized and frozen.²⁴² It is estimated that approximately 2.7% of global GDP, worth US\$1.6 Trillion in 2009 is available to money launderers.²⁴³ Of these figures the estimated value of illicit funds leaving developing countries was estimated as worth close to \$1 Trillion ²⁴⁴ the majority of which was smuggled out using trade based money laundering techniques by criminals linked to arms smuggling, drug trafficking, terrorism or public corruption.²⁴⁵

²⁴¹ Kar, D., & LeBlanc, B. (2013). Illicit financial flows from developing countries 2002-2011

²⁴² UNODC. (2011). Estimating illicit financial flows resulting from drug trafficking and other transnational organized crimes

²⁴³ UNODC. (2011)

²⁴⁴ Kar, D., & Spanjers, J. (2014). Illicit financial flows from developing countries 2003-2012

²⁴⁵ Mauro, J. S. (2014). THE NEW ECONOMY IN FINANCIAL CRIMES. Understanding the effects of under-invoicing, double invoicing and false invoicing in trade-based money laundering and terrorist financing (TBML & TF) schemes ACAMS

According to Stack ²⁴⁶ (2015) on his work on illicit trade in the former Soviet Union (FSU), there is little doubt that trade-based money laundering played a significant role in the 1990s in obscuring illicit trade movement out of the former Soviet Union, with estimates of \$9 billion dollars being lost to the FSU between 1995-1999. More recent research from Global Financial Integrity,²⁴⁷ which is an NGO specialising in the recording of illicit trade data, suggested that the figure from 1991 to date is now in the region of between \$211bn and \$782bn.

Money laundering often occurs between developing economies and developed western economies,²⁴⁸ according to Kar & LeBlanc, (2013) it is estimated that over \$946 billion was transferred from developing countries by illicit transactions in 2011. One of the reasons that illicit flows are an attractive option to money launderers is because there is more guarantee of a stable financial and political environment with less corruption in developed economies,' as opposed to leaving the money in developing economies where there is also a risk of the money losing value or being lost completely through corruption.²⁴⁹

²⁴⁶ Stack, G. (2015). Baltic shells: On the mechanics of trade-based money-laundering in the former soviet space. *Journal of Money Laundering Control*, 18(1)

²⁴⁷ Kar, D., & Freitas, S. (2013). *Russia illicit financial flows and the role of the underground economy*. Washington, DC: Global Financial Integrity. Retrieved from http://www.gfintegrity.org/wp-content/uploads/2013/02/Russia_Illicit_Financial_Flows_and_the_Role_of_the_Underground_Economy-Web.pdf

²⁴⁸ Kar, D., & Spanjers, J. (2014). *Illicit financial flows from developing countries 2003-2012*.

²⁴⁹ Amone, M & Borlini, L. (2010) "International Anti-Money Laundering Programs." *J of Money Laundering Control* 13, no. 3: doi:10.1108/13685201011057136.

2.1.4 Banking Services and TBML

The following case studies provide examples of how different elements of the banking and financial services can be exploited to facilitate money laundering activity. In order to accurately depict TBML patterns, a detailed collection of data on the buyers and sellers, as well as the goods and methods of transportation are all required, before an accurate picture of illicit trade can be properly established.²⁵⁰ However, many of the factors mentioned in the following section can be recognised and flagged as alerts, especially if risk assessments are detecting a number of concerns, including difficulty in establishing the true ownership of the business, and/or a lack of information on the bank customer. The next section looks at some of the adaptations that criminals have made in order to circumvent recent AML regulation in the financial services sector.

2.1.5 Hijacking Customer Accounts

A new phenomenon in money laundering in order to avoid detection, is to temporarily hijack another client's account and synchronise a money laundering transaction to match the legitimate client's transaction. This is sometimes referred to as cuckoo smurfing²⁵¹ after the bird that uses another bird to raise its chicks unbeknown to the new parent.

²⁵⁰ Kar, D., & Freitas, S. (2012). Illicit financial flows from china and the role of trade misinvoicing. Global Financial Integrity, Washington, DC.

²⁵¹ 'Cuckoo Smurfing' is an advanced form of smurfing whereby the knowledge of legitimate accounts, and transactions are hijacked by criminals for money laundering purposes, without the

Hijacking requires a corrupt or criminal involvement at one stage of the transaction, for example a client in Nepal wishes to purchase goods worth £10,000 from a UK based company through the services of a Hawala. The money is deposited with a local Hawala ²⁵² in Nepal ready for transmission to the bank account of the UK Company. A criminal gang is informed of this transaction and the cash is then removed from the Nepal system and given to the gang. In exchange the gang uses its UK contacts who are holding illicit funds in pounds sterling and they deposit this money through different branches in the UK account of the company matching the amount of the transaction from Nepal.²⁵³

account holders' knowledge. This system has been compared to the activity of the cuckoo bird, which sneaks its eggs into other birds' nests and lets them hatch and rear its offspring. The criminal gang uses the knowledge of legitimate accounts and transactions and hijacks this information for money laundering purposes, without the account holders' knowledge. No money is taken from the account holder but the knowledge of the type and amount of a transaction is hijacked for the criminals to alter to suit their own means. Usually this entails diverting legitimate money in the middle of a trading transaction and replacing it with dirty money.

²⁵² FATF 2013. The role of Hawala and other similar service providers in money laundering and terrorist financing. Retrieved May, 10, p.2014. <https://www.imolin.org/pdf/imolin/Role-of-hawala-and-similar-in-ml-tf-1.pdf>

²⁵³ An example of the possible process can be whereby an innocent individual in Nepal is wanting to purchase the latest satellite phone sold by the manufacturer based in the UK, inclusive of delivery its cost price is advertised as £10,000. So the client visits a local Hawala to deposit the money (based on the currency conversion of the day) requesting it be sent to the UK based company so an order can be processed for the satellite phone. Here the Hawala agent (with dubious intentions) discusses the transaction outline with the client to understand the requirement and offers to ask a trusted friend of his in the UK to order and dispatch the goods on his behalf ensuring the product is safely delivered to the client (with the product paperwork and warranty remaining in the name of the client). The client sees this as not an issue as the desired result is the same of obtaining the phone but with the added assurance that a UK resident can oversee all matters in case of any issue arising, (which if he was to attempt to resolve with the language barrier and thousands of miles between all being tricky). Unbeknown to the client, the Hawala agent liaises with local criminal clientele of his who are linked in part to a criminal gang in the UK, stating that (for a small fee to the agent) £10,000 worth of rupees (based on the currency conversion of the day) will be available to collect from his office by any person authorised on behalf of the gang with no paper trail and in return their contacts ensure that the purchase of the satellite phone in the UK is sent to the client (via the agent forwarding the clients contact and order details to them). This is seen to be a paperless transmission for the criminal gang as the UK arm of their empire are ever aiming to move parts of its illegally gained proceeds abroad without detection or paperwork. The local gang makes contact with its UK arm informing them of the required task. The UK arm of the gang uses £10,000 of illegally acquired money to innocently and legally purchase the satellite phone through the normal UK process of a bank deposit (or through numerous small amounts i.e part payments towards the order) for a product purchase (under the guise of a gift for a Police station in a mountainous terrain in Nepal) effectively having the product manufacturer send out an order delivered to the client in Nepal and benefitting the criminal gang in

*"The term hawala is traditionally associated with a money transfer mechanism that operated extensively in South Asia many centuries ago and had strong links along traditional trade routes in Middle East and parts of East Africa. It operated as a closed system within corridors linked by family, tribe or ethnicity. In recent times, the term hawala has often been used as a "proxy" to describe a wider range of financial service providers, beyond these traditional and geographically tied systems. In other countries, the term hawala is actually not used at all. However, there is a general recognition of the existence of hawala or hawala-like providers in many jurisdictions and of the type of methods they use and services they provide. There is also a general agreement as to what they are not: global money transfer networks (including agents) operated by large multinational money transmitters and money transfers carried out through new payment methods including mobile money remittance services."*²⁵⁴

In order for businesses to undertake any trade transaction they require documentation²⁵⁵ as evidence in order to ship the goods and

Nepal and its UK arm, in having been able to move £10,000 from the UK to Nepal without any paper trail or any suspicion being raised.

²⁵⁴ FATF 2013. The role of Hawala and other similar service providers in money laundering and terrorist financing. Retrieved May, 10, p.2014. <https://www.imolin.org/pdf/imolin/Role-of-hawala-and-similar-in-ml-tf-1.pdf>

²⁵⁵ United Nations Layout Key for Trade Documents

Source: UNECE through its Center for Trade Facilitation and Electronic Business (UN/CEFACT)

Source: http://www.unece.org/fileadmin/DAM/cefact/recommendations/rec01/rec01_ecetrd137.pdf

provide legal records of the business carried out. An example of documentation has been broken down into two categories.

1. Financial documents: *The two main financial instruments are bills of exchange and promissory notes. Both are negotiable, so that they can be used to raise finance. Additional documents: Commercial invoice; A pro-forma invoice; Consular invoice or certificate (a standard form prepared by the destination country).*²⁵⁶
2. Insurance documents: Cargo insurance; Packing list; Bills of Lading; Export Cargo Shipment Instruction (ECSI); CMR form (Convention des Marchandises Routiers); CIM consignment note (Convention International des Marchandises par Chemin de Fer); Air Waybills (AWBs); Sea Waybills; Courier Waybills; Standard shipping notes; Dangerous Goods Note; Certificates of Origin (EU Certificates of Origin, Arab-British Chamber of Commerce Certificates of Origin, EUR1 Movement Certificates); Certificate of Conformity; Health certificates.²⁵⁷

In criminal activity the only difference is that many of these trade documents are also forged and illegal.²⁵⁸ The complexities of using the trade misinvoicing systems are well recognised by regulatory bodies and

²⁵⁶ RBS. (2012). "A guide to trade documentation: financial documents". RBS Transaction Services, RBS, UK. Available at: www.opentoexport.com/article/a-guide-to-trade-documentation-financial-documents/

²⁵⁷ RBS. (2012). "A guide to trade documentation: financial documents". RBS Transaction Services, RBS, UK. Available at: www.opentoexport.com/article/a-guide-to-trade-documentation-financial-documents/

²⁵⁸ And vice versa, whereby the documentation can be genuine but the cargo can be false. As such it works both ways.

AML compliance officers. FATF (2006) has identified TBML as using classic misinvoicing schemes, which have then been developed into complicated and complex schemes of fraudulent business.²⁵⁹

2.1.6 Enterprise of Letters Of Credit

International trade is not regulated by an international body of law,²⁶⁰ in other words trading goods across national borders is an enterprise in trust. To mitigate against the high risks that a buyer will not pay after the goods have been shipped or sellers do not ship the goods after payment is received banks step in to add a layer of trust to the transaction.²⁶¹ The role of banks in the control and management of money laundering is strongly linked to the role they play in facilitating international trade. Briefly we explore what, if any, legal or regulatory responsibility banks have to interrogate the underlying transactions with which they are involved, given the prevalence of trade based money laundering.

The principle way in which banks facilitated trade between sellers and buyers in different countries is the letter of credit. Letters of credit are guarantees issued by the bank of a buyer to the bank of seller that goods will be paid for, when the criteria stipulated by the letter of credit are met. As such, they are powerful mechanisms for international trade, because

²⁵⁹ Stack, G. (2015). Baltic shells: On the mechanics of trade-based money-laundering in the former soviet space. *Journal of Money Laundering Control*, 18(1)

²⁶⁰ McDonnell J and Roiser. D 2016 'Red Tape, Undermining the certainty of international trade finance.' <http://www.kwm.com/en/uk/knowledge/insights/undermining-the-certainty-of-international-trade-finance-20151109>

²⁶¹ Coker. D, 'Letters of Credit, Bills of Lading & International Trade Finance Documentation Issues Important in Litigation.' <https://www.hg.org/article.asp?id=18850>

they generate trust between sellers and buyers who do not necessarily have an existing business relationship.

What makes letters of credit especially powerful in this context is that they are considered independent of the underlying transaction – in other words the banks rely solely on the documentation, and do not concern themselves with what is actually traded, and how. This is what banks call the “autonomy principle”²⁶² which makes letters of credit “as good as cash” within international trade. Because banks are not obliged to interrogate the underlying transaction, letters of credit are ripe for abuse by TBML organisations, mainly criminal and terror networks.

The requirements of a letter of credit can vary, most will require proof of insurance, certificate of origin, packing lists, invoices, industry certifications of safety or sanitation, and transportation documents such as a bill of lading.²⁶³ Bills of lading are essentially formal documents that acknowledge the shipment of goods by the seller, and act as evidence that specified goods have been shipped to a specified destination. A bill of lading will be an important document that must be submitted when meeting the terms and conditions of the letter of credit. A bill of lading will detail precisely what is contained in the cargo and at what quantities. Shipping agents and receiving buyers use bills of lading to check that what

²⁶² McDonnell J and Roiser. D 2016 ‘Red Tape, Undermining the certainty of international trade finance’ <http://www.kwm.com/en/uk/knowledge/insights/undermining-the-certainty-of-international-trade-finance-20151109>

²⁶³ In the process of shipping and the freight chain, a bill of lading is considered to be one of the most important documents and has 3 basic purposes or roles: Evidence of contract of carriage; Receipt of goods; and Document of title to the goods.

was shipped is in fact what arrived, and act as a receipt of the goods. The bank's sole responsibility is to validate all documentation is correct, complete and original. The bank does not have an obligation to investigate the nature of the transaction, the financial history of the seller, or the regulations followed by the seller's bank (who will take receipt of the funds).

So, whilst banks have every right to refuse payment when fraud is clearly indicated in the documentation itself,²⁶⁴ once all tests of validity have been passed with regard to the documentation the banks are obliged to issue payment.²⁶⁵

*"Bank's concern themselves only with the terms of the letter of credit, and not with the terms and requirements of the sales contract. While letters of credit are not strictly governed by any international laws, the principles of strict compliance have evolved from international banking practices, as enunciated in the Uniform Customs and Practice for Documentary Credit."*²⁶⁶

The issuing of letters of credit is a formidable task that requires batches upon batches of documentation, as well as administrative

²⁶⁴ McDonnell J and Roiser. D 2016 'Red Tape, Undermining the certainty of international trade finance' <http://www.kwm.com/en/uk/knowledge/insights/undermining-the-certainty-of-international-trade-finance-20151109>

²⁶⁵ Bank's concern themselves only with the terms of the letter of credit, and not with the terms and requirements of the sales contract. While letters of credit are not strictly governed by any international laws, the principles of strict compliance have evolved from international banking practices, as enunciated in the Uniform Customs and Practice for Documentary Credits, drafted by the ICC Banking Commission on Banking Technique. (Bijl. M, 'Fundamental Breach in Documentary Sales Contracts The Doctrine of Strict Compliance with the Underlying Sales Contract', European Journal of Commercial Contract Law, vol. 1, 2009 p. 19.)

²⁶⁶ Ibid.

stamina. Errors, accidental or intentional, within the documentation that can lead to suspicions of money laundering are sometime, and often by design, quite small. Being able to compare originals with previously transmitted copies is for instance standard procedure as per the UCP 600.²⁶⁷ Date, technical, cargo modifications, small name changes can all effectively change the underlying transaction, and lead to money laundering – however banks, once engaged in the issuing of a letter of credit are unlikely to have the technical insight to know when documentation fraud has been committed with a LC.²⁶⁸

With AML and ABC ²⁶⁹ gaining traction amongst regulation agencies and terrorism task forces, banks are being asked to refine and bolster their anti-money laundering processes, particularly with regard to applications for letters of credit. Banks have the greatest amount of control over the process at the application stage. At this stage, they can request validation of identities of all participants, regulatory compliance of any partner banks and details of the country of origin. In this way, international agencies such as the FATF hope that banks will begin to accept a degree of responsibility for preventing money laundering, as they are key fulcrums in facilitating international trade.

²⁶⁷ The UCP (Uniform Customs & Practice for Documentary Credits) 600 are procedural guidelines for banks in writing and issuing letters of credit issued by the International Chamber of Commerce. International Chamber of Commerce. 2006. ICC uniform customs and practice for documentary credits. Available at:

<http://search.ebscohost.com/login.aspx?direct=true&scope=site&db=nlebk&db=nlabk&AN=817836>.

²⁶⁸ Chehashim. R & Mahdzan. N (2014) Fraud in letter of credit transactions: The experience of Malaysian bankers. *International Journal of Law, Crime and Justice* 42 (2014) 224e236 retrieved from: https://umexpert.um.edu.my/file/publication/00008277_103078.pdf

²⁶⁹ (ABC) Anti-bribery and corruption.

2.1.7 UCP 600 and Money Laundering

The UCP 600, similar in fact to the FATF, is a set of recommended guidelines that are in no way enforceable by a global authority. In any case, the wording of the UCP 600, as it currently stands, possibly promotes, rather than hinders, money laundering because it specifically states that the agreement of credit, is distinct from the underlying sale – even if the sale is detailed within the letter of credit.

So, even those banks that assiduously follow the UCP 600, are not required to understand any details of the underlying transaction whatsoever.²⁷⁰ The wording is in fact unambiguous in its definition of the roles and responsibilities of banks in the issuing of LCs:

“The UCP rules widely govern commercial letters of credit globally. They were first published in 1933 and are used by banks all over the world. The most current version of the rules is UCP 600, which came into effect from 1 July 2007 and replaced UCP 500. Article 4 of the UCP600 provides that: ‘A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or to fulfil any other obligation under the credit is

²⁷⁰ It is of use to point out that that so far as UCP 600 is concerned, the issuing bank should take on themselves the responsibility of checking the documents before transmitting money and of benefit to the industry as a whole would be for the Banking Committee of the International Chamber of Commerce to review their current practice.

*not subject to claims or defences by the applicant resulting from its relationships with the issuing bank or the beneficiary'. Article 5 UCP 600 further provides that: 'Banks deal with documents and not with goods, services or performance to which the documents may relate.'*²⁷¹

The UCP 600 goes further to state that:

*"All Letters of Credit issued under UCP600 are irrevocable. This can neither be modified nor cancelled without the agreement of all the parties concerned. The payment by the Issuing Bank is guaranteed provided that the Beneficiary (Seller/Exporter) satisfies all the terms and conditions of the Letter of Credit."*²⁷²

2.1.8 Over and Under Invoicing

One of the main forms of TBML activity is to either over estimate or under estimate the price of invoices. Case studies described in the FATF report ²⁷³ highlight how banks may be involved in facilitating TBML transactions by not having the relevant documentation to fully understand the transaction process or realizing the full value of the shipments. In

²⁷¹ Ramandeep Kaur Chhina , (2016),"Managing money laundering risks in commercial letters of credit", Journal of Money Laundering Control, Vol. 19 Iss 2 pp. 158 - 168

Permanent link to this document:

<http://dx.doi.org/10.1108/JMLC-05-2015-0019>

²⁷² Simmons & Simmons. "Structures and Solutions in Trade Finance". Simmons & Simmons, London, UK. Available at :

www.elexica.com/~media/Files/Microsites/Structures%20Solutions%20in%20Trade%20Finance/Structures%20and%20Solutions%20in%20Trade%20Finance%20Portrait.pdf

²⁷³ FATF. (2006). Trade based money laundering. France. Financial Action Task Force

these scenarios although business checks and assessments were undertaken within the banks, the use of false shipping documentation and falsified documents by the client effectively rendered standard risk assessment systems null and void.

This falsification and over invoicing process can be used in either direction depending on where the money needed to be transferred. From this it can be seen that trade-based money laundering is a complex mini financial system of its own, which involves a number of partners, transactions and goods.²⁷⁴ The challenge for the banking sector is to develop a system that will unravel those elements that are relevant to their work as a financial institution; rather than considering themselves as an extra arm of law enforcement.

For the banking sector generally and especially for global banks involved in international transfers, there are a number of points that need to be acknowledged when implementing the current AML requirements. The main one is to be clear how TBML affects banking business and therefore establish what the benefits are to addressing and improving AML compliance within the banking structure. In other words, the financial sector needs to develop its own understanding and definition of TBML as it applies to their work.

²⁷⁴ Sullivan, C., & Smith, E. (2011). trade-based money laundering: Risks and regulatory responses. Canberra: Australian Institute of Criminology.

2.1.9 Detecting Trade Anomalies.

Research by Hong, Pak & Pak (2014)²⁷⁵ focused on the specific trading of bananas between the US and the Caribbean and Latin America. In their work they focused on a 10-year period and calculated by the weights and quantities, how much discrepancy existed between global trade prices and those in the US study. They looked at three different methods for analysing trade patterns. The first was partner country trade data comparing exports and imports stated between both countries, the second was the price filter analysis approach which uses an arm's length calculation for each product, set against a maximum and minimum set of values. The final method supported by the research was an arm's length approach again, but this time using US data UNCTAD (UN Conference on Trade and Development) with the range being 10% either side for the max and min range. Their study highlighted how some trade data filter methods can obscure the activities that are actually taking place and are not able to detect the anomalies in pricing for certain situations.

It is important to note that trade misinvoicing is not the only mechanism by which TBML activity occurs and some researchers have identified a weakness in trying to tackle TBML and data analysis solely from this standpoint.²⁷⁶ However, it is perhaps reasonable to assume that it is the largest form of TBML activity since it is the simplest method to implement and provides challenges for banks to fully verify without an

²⁷⁵ Hong, K., H. Pak, C., & J. Pak, S. (2014). Measuring abnormal pricing – an alternative approach. *J of Money Laundering Control*, 17(2), 203-218. doi:10.1108/jmlc-11-2013-0043

²⁷⁶ Soudijn, M. (2014). A Critical Approach to Trade-Based Money Laundering. *Journal of Money Laundering Control* Vol 17, Iss 2, 230-242.

onsite shipping inspection or detailed knowledge of international prices. It is however the easiest method to check internationally as databases are being developed specifically for the analysis of shipping prices,²⁷⁷ as Yalti and Demir highlighted in their study on trade misinvoicing in Turkey.

“As opposed to the general trend in misinvoicing, exports to China are underinvoiced and imports are over invoiced. We also analyse how the liberalization policies and the customs union agreement with the European Union countries affect trade misinvoicing. We find that, with trade liberalization policies, import misinvoicing has decreased at the aggregate level.”

This technique has the potential to be detected by using data management software. Other methods of TBML activity such as smuggling are more covert and rely on custom checks or police surveillance in order to detect.

²⁷⁷Yalta, A. Y., & Demir, I. (2010). The extent of trade mis-invoicing in turkey: Did post-1990 policies matter?

2.1.10 Criminal Behaviour

In order to fully understand the activities of the TBML criminal it is important to develop an understanding of the behaviour and motivation of a client who might be involved in TBML activity. However, it is beyond the scope of this research project to consider the predicate crimes and motivations of all of those involved in illegal criminal activity that might generate the dirty money initially. The focus instead is on the behaviour of the money launderers acting either on behalf of a criminal gang, or who are senior criminals who are receiving the money and acting alone.

2.1.10.1 Corporate Fraud

A common misnomer regarding the motivation of many of the Wall Street scandals, was the notion that it was individuals who were 'bad apples' in the financial barrel. In other words, these individuals were greedy and acted alone to secure their own personal financial gain. Hansen & Movahedi, (2010)²⁷⁸ talk about the dangers of pursuing this myth of individual greed as the sole cause of financial crime, especially amongst the large investment companies and Wall Street. They apply a systemic analysis to suggest that instead financial and white collar crime occurs within a combination of culture, Wall street ideology and compensation structures, which permeated the mind set of all involved and which along with a weak mechanism of regulatory oversight all became

²⁷⁸ Hansen, L. L., & Movahedi, S. (2010). Wall street scandals: The myth of individual greed1. Sociological Forum, 25(2), 367-374. doi:10.1111/j.1573-7861.2010.01182.

factors underpinning the financial scandals which have come to light in recent years. This lack of understanding is captured by Hansen (2009) who describes the lack of engagement by social science academics on this topic, “*those in the social sciences have done little to assist in policy making or theory building in the case of unethical behaviour.*” ²⁷⁹

One of the reasons for this reluctance might be because there is a fine line to be crossed, in financial business, between unethical behaviour and criminal behaviour, especially for white collar crime such as insider trading. The lack of successful prosecutions has been blamed on the inability to gather enough evidence to determine that a fraudulent crime had been committed, rather than declare that an organisation had been acting unethically or had made a genuine mistake. Some researchers have suggested that it is as much about the politicisation of white collar crime ²⁸⁰ with political leaders wary of pursuing major banks and lacking the political drive to review the legislation. Defining unethical behaviour then becomes part of the topic of social corporate responsibility where financial organisations subscribe to and support their own understanding of ethical business behaviour. The challenge for regulators is to ensure that there are reasonable levels of overlap between accepted international approaches to preventing money laundering and the banks own code of ethics towards staff and client behaviour.

²⁷⁹ Hansen, L. L. (2009). Corporate financial crime: Social diagnosis and treatment. *Journal of Financial Crime*, 16(1), 28-40. doi:10.1108/13590790910924948 p29

²⁸⁰ Hansen, L. L. (2009).

2.1.10.2 False Identification

TBML crime requires a certain level of ingenuity and imagination to invent schemes that can circumvent AML regulation. The successful criminals can adapt in a multitude of ways, to exploit weaknesses or gaps in any financial trading system.²⁸¹ One of the ways for clients to avoid detection in AML risk assessment is by thwarting the customer due diligence (CDD) process, through the use of a false identity. Buying fake identities appears to be a fairly straightforward process on Dark Net sites, such as Angora or through other sites dealing specifically with false passports.²⁸² The increase in sites available for these types of purchases has been noted, where some researchers into Darknet activity have calculated that in the six months after the Silk road site was taken down by the FBI, sales in illicit drugs increased by 100%.²⁸³ This is also supported by the reported speed at which replacement sites appeared after the closure of the Silk Road site in October 2013.²⁸⁴ The rise in cybercrime²⁸⁵ means that as well as using false identities, criminals are also using stolen credit card details, stolen details from PayPal or other internet payment systems and forged details on other forms or documents needed by the bank to support and verify their new identity. In short it is no longer

²⁸¹ Curtis Williams, C. (2013). A burning desire. *J of Money Laundering Control*, 16(4), 298-320. doi:10.1108/jmlc-01-2013-000

²⁸² Aplus (2014) 5 Scary Things Anyone Can Buy In the Darknet's Illegal Market Retrieved from <http://applus.com/a/Darknets-illegal-drug-and-weapons-market>

²⁸³ Wong, J.I (2014) Dark Markets Grow Bigger and Bolder in Year Since Silk Road Bust <http://www.coindesk.com/dark-markets-grow-bigger-bolder-year-since-silk-road-bust/> accessed 2nd January 2016

²⁸⁴ Bradbury, D (2013) Silk Road alternatives emerge as public hammers FBI bitcoin wallet <http://www.coindesk.com/silk-road-alternatives-emerge-public-hammers-fbi-bitcoin-wallet/> accessed 2nd January 2016

²⁸⁵ FATF. (2014). Transparency and beneficial ownership. France: Financial Action Task Force. FATF Guidance. Retrieved from <http://www.fatf-gafi.org/documents/guidance/transparency-and-beneficial-ownership.html>

acceptable for a risk assessment framework to accept identity documentation at face value, and instead this needs to be used in conjunction with other risk factors.

There is a growing concern, of the selling and production of falsified documents ²⁸⁶ and the implications for criminal activity. These ID documents can be falsified for a number of reasons including terrorism, underage drinking as well as identity theft and money laundering. Law enforcement officers are slowly being trained in the skills used for detecting the use of false identities and some of these skills could be used by banking officials in their Beneficial Ownership Information (BOI) and Customer Due Diligence (CDD) assessments. Skills such as knowing that owners of false identities will have to have remembered all their new details, therefore questions on CDD or BOI assessments should avoid using straightforward easy to recall answers.

2.1.10.3 Straw Men

Another scheme that criminals use to avoid running into problems with the initial CDD checks, is to use legitimate people as fronts to their own activities. These people may be existing clients in the bank or new clients who have no apparent connection to the criminal organisation.²⁸⁷ These clients are known as 'Straw Men' and will pass initial banking CDD checks in order to enable the criminal organisation to carry out their

²⁸⁶ NCA (nd) Identity Crime <http://www.nationalcrimeagency.gov.uk/crime-threats/identity-crime> accessed 2nd January 2015

²⁸⁷ Egmont Group. (2000). FIU's in action. 100 cases from the Egmont Group

transactions undetected. In these situations, banks need to be aware of monitoring account activity as well, but also to use beneficial ownership information. The BOI becomes even more important in these situations in order to determine who is actually behind the flow of money and to track where the money is actually going.

2.1.10.4 False Shipping Documents

In addition to falsifying identification documents, clients involved in TBML activities can also present other business documentation to the bank that has been altered, forged or acquired illegally. The nature of the forged document will depend on the transaction that they wish to undertake and the underlying purpose of the criminal activity; therefore, understanding the nature of the business may give some clues as to the nature of the crime.²⁸⁸ Part of the ongoing training needs of bank employees would be the need to develop and then constantly update a system of typologies of typical TBML or money laundering offences or schemes that have been uncovered.²⁸⁹ This is one method that might support the bank so that AML officers know the types of activity to look out for. Banks do not need to look for everything that might be highlighted, but there might be specific types of activity that would suit the bank's own skills and expertise, for example this could include looking for sudden withdrawals of large amounts of cash especially after receiving a shipment

²⁸⁸ Kar, D., & Freitas, S. (2012). Illicit financial flows from china and the role of trade misinvoicing. Global Financial Integrity, Washington, DC.

²⁸⁹ GT Canada AML Survey Result. (2015). GT Canada AML survey result. (National Anti-Money Laundering survey report 2015)

of goods that were valued at a lot lower than either the shipping documents show or reflected in the money that arrived in the bank.

2.1.10.5 United Kingdom's Financial Conduct Authority on Training

It has been found that banks do not necessarily have the correct procedures and ethical frameworks in place to assist staff in detecting suspicious transactions. A part of this negligence is the lack of dedicated anti-money laundering training. Staff should be routinely updated on the latest trends and criminal behaviour patterns and be regularly reminded of both the causes and consequences of ML. In this way, staff would become more alert and knowledgeable, in their role at the front lines of detecting suspicious transactions and documents.

The 2013 publication²⁹⁰ by the UK's FCA highlighted this in very clear words. Point 90 within the publication stated:

*"A number of trade finance staff had passed a globally recognised professional qualification for international trade finance practitioners. However, this qualification did not cover, in any detail, the financial crime risks in trade finance business."*²⁹¹

Point 91 within the publication stated:

²⁹⁰ The FCA, Banks' Control of Financial Crime Risks in Trade Finance (Thematic Review, TR13/3, July 2013) (hereinafter "the FCA Report") Available at : <https://www.fca.org.uk/publication/thematic-reviews/tr-13-03.pdf>

²⁹¹ Ibid. Point 90.

“We were therefore concerned that, although all banks had generic money laundering/terrorist financing and sanctions training programmes, many banks had not delivered adequate training to relevant staff on the specific money laundering risks in trade finance. Many banks’ trade-specific financial crime training was focused on sanctions risks, with limited coverage of money laundering. One bank’s training material did not mention any of the FATF/Wolfsberg red flags. While it was encouraging to see that training on sanctions risks was generally well-considered, we were disappointed that many banks had not placed an equivalent focus on money laundering and terrorist financing risks.”²⁹²

Point 92 within the publication stated:

“As a result, some trade processing staff did not have the knowledge or awareness to identify transactions that posed a high risk of money laundering and had not made appropriate enquiries to satisfy themselves about potential money laundering risks. In addition, staff outside trade processing teams were often unable to challenge the decisions taken by trade processing staff.”²⁹³

²⁹² Ibid. Point 91.

²⁹³ Ibid. Point 92.

2.2 Trade Based Money Laundering Detection

This next section considers the processes that banks currently use in order to detect and assess for the risks posed by TBML activity.

2.2.1 Banking and TBML

Banks have played a key role in detecting money laundering activity in the UK since the passing of the Drug Trafficking Offences Act 1986 and they remain at the forefront for detecting much of the illegal activity today.

The classical description of money laundering activity has also been used to describe TBML activity,²⁹⁴ however trade-based money laundering may do all or none of the three stages described by McDowell & Novis (2001) as other authors have suggested.²⁹⁵ Firstly, by moving value through goods there may be no placing of illegally obtained cash into the banking sector. Instead letters of credit may be used or the cash may already have been converted directly into goods.²⁹⁶ Secondly the layering and integrating processes are ongoing in TBML transactions through a series of trading interactions. These transactions may also occur across several different countries, or trading zones and/or banking facilities.

²⁹⁴McDowell, J., & Novis, G. (2001). The consequences of money laundering and financial crime. *Economic Perspectives*, An Electronic Journal of the U.S. Department of State, 6(2).

²⁹⁵Soudijn, M. R. J. (2014). A critical approach to trade-based money laundering. *J of Money Laundering Control*, 17(2), 230-242. doi:10.1108/jmlc-01-2013-0001.

Zdanowicz, J. (2009). Trade Based Money Laundering and Terrorist Financing. *Review of Law and Economics* Vol 5 No.2, 855-878.

²⁹⁶Zdanowicz, J. (2009). Trade Based Money Laundering and Terrorist Financing. *Review of Law and Economics* Vol 5 No.2, 855-878.

Therefore, the pattern of behaviour for TBML and banking transactions would be more aligned to:

- 1) Application for a loan or letter of credit to purchase and export goods
- 2) Placement of cash or repayment of loan in bank supported by legitimate transfer of goods details
- 3) Wire transfer of money to purchase new goods supported by invoices and import documents. Or using the original terminology, ***Integration – Placement – Layering***. This therefore makes tracking money being placed into the banking system that much harder since it has potentially already been integrated into the system before it is placed in a bank.

For the banking sector in general, but especially for global banks who are involved in international transfers, there are a number of factors that need to be acknowledged when implementing anti money laundering regulations. Trade finance is one of the most important aspects of maintaining the economy²⁹⁷ along with confidence in the banking sector. Trade-based money laundering therefore has the potential to distort and upset both of these components if appropriate regulation and control is not maintained. However, the main question to be asked is, how does TBML affect banking business and why does the financial sector need its own understanding and definition of TBML?

²⁹⁷ FCA. (2013). Bank's control of financial crime risks in trade finance. London: Financial Conduct Authority.

2.2.1.1 TBML Definition in Banking

For the banking sector the definition and application of Trade-based money laundering is most commonly used during the risk assessment of a client's overall business proposal. Whilst this is part of a standard 'Know Your Customer' approach, there are additional TBML components. The first is to determine the source of the materials being used (cash /goods or services) and secondly to assess whether these are feasible for the business proposition under consideration. The bank cannot determine whether these goods or money are from illegal gains, but it can highlight whether it is possible to run this proposal using cash or goods acquired illegally or whether another form of business might be operating in the background to supply illegal cash.

In this context perhaps a more accurate definition of TBML for the banking sector would be *"The use of the financial services to facilitate the movement of money, through the use of fraud or deception"*. This clearly defines the role that banks have in engaging with TBML activities, since their own systems of risk assessment will have been compromised, by the deception process. The use of the term 'money' is important to reintroduce into the banking definition because that is the part of the TBML transaction that will manifest in the bank risk assessment.

2.2.2 Risk Assessment

Risk assessment underpins many of the modern banking approaches to AML detection. However, the biggest challenge facing the banking sector is how to develop a model of risk assessment that is dynamic enough to be able to keep abreast of modern AML breaches, whilst simultaneously ensuring that banking personnel are able to understand and able to implement the system easily. The current shift in risk assessment is towards a system of risk based approaches (RBA)²⁹⁸ whereby the highest money laundering risk should receive the highest amount of attention and resources. The traditional and alternative system is to use a strictly rule based approach whereby clearly defined procedures and questions are rigidly adhered to and applied equally to all accounts regardless of risk. Although a risk based model cannot replace the ease of the rules approach, it can integrate the two approaches in order to filter attention onto the most likely high risk scenarios.

The EU Third Directive on Money Laundering also advocates for a risk based approach to dealing with AML compliance and risk assessment within banks. Demetis and Angell (2007) in their paper are highly critical of risk based approaches and use a systemic analysis to highlight the main flaws in such an approach. They describe two types of risk that banks have to address, firstly 'taking risks' where the bank is actively undertaking actions that have an underlying risk component and 'being at risk' where

²⁹⁸ Amone, M & Borlini, L. (2010) "International Anti-Money Laundering Programs." J of Money Laundering Control 13, no. 3: doi:10.1108/13685201011057136.

outside forces threaten the business of the bank. They also highlight that risk is not a straightforward process and its complexity can be further misunderstood through the simplified terminology often used to describe its' use in banking, such as 'risk control' or 'risk management'.²⁹⁹

Demetis and Angell (2007) are equally sceptical of the lack of guidance being offered to banks to try and explain how a risk based system would actually operate in reality. They suggest that the lack of guidance is itself indicative of the impracticalities of such an approach. *"The fact that significant flexibility is being allowed to the financial institutions implies that the regulators cannot provide substantial guidance in dealing with the risk-based approach."*³⁰⁰ Subbotina, (2009) also describes regulators as moving beyond the bounds of the banking environment in their attempt to assess ML risk and yet providing little in the way of guidance as to how to interpret the legislation in practice.

Instead of guidance there appears to be a strategy put in place to increase the regulatory pressure on banks with the subsequent threat of legal action for non-reporting. This has resulted in a level of over reporting of suspicious alerts,³⁰¹ which has meant that financial intelligence units now have less information to work from since it is unclear which reports are genuine red flag alerts and which are knee jerk reactions. In Germany the FIU has noted an increase of over 100% between the number of STRs

²⁹⁹ Demetis, D. S., & Angell, I. O. (2007). The risk-based approach to AML: Representation, paradox, and the 3rd directive. *J of Money Laundering Control*, 10(4), 412-428. doi:10.1108/1368520071083090

³⁰⁰ Demetis, D. S., & Angell, I. O. (2007) p420

³⁰¹ Takáts, E. (2007). A theory of "crying wolf": The economics of money laundering enforcement. Ana Lucia Corofnel. IMF Working Paper

in 2003 (6,802) and the figures released in 2012 (14,361).³⁰² Other FIUs such as the Belgium FIU also saw an increase from 5,896 in 2012 up to 7,078 in 2013. These figures represent substantiated disclosures, for the Belgium FIU this figure was from a total received of over 22,000 notifications.

Overall this regulatory led system has effectively increased the potential risk of ML activity becoming undetected, since without the ability to tell the difference between a suspicious and non-suspicious alert the central component to any risk based approach is lacking.³⁰³

The growth in international money laundering is due to continue with a predicted 6-10% increase in global ML activity.³⁰⁴ The problem of ML detection is therefore destined to continue unless a different approach to assessing compliance and risk is introduced and understood by the regulators. The problem at the moment is that AML compliance cannot be quantified very easily on an incremental scale, in other words banks are either compliant or they are not.³⁰⁵ Researchers have also determined that in the current system, compliance does not appear to be a clear indicator of what needs to be addressed within the banking sector, in order to improve AML detection *"The case studies highlightedthat compliance*

³⁰² 2012 Annual Report FIU Germany. (2012). Germany

³⁰³ Demetis, D. S., & Angell, I. O. (2007). The risk-based approach to AML: Representation, paradox, and the 3rd directive. J of Money Laundering Control, 10(4), 412-428. doi:10.1108/1368520071083090

³⁰⁴ Amone, M & Borlini, L. (2010) "International Anti-Money Laundering Programs." J of Money Laundering Control 13, no. 3: doi:10.1108/13685201011057136.

³⁰⁵ Demetis, D. S., & Angell, I. O. (2007). The risk-based approach to AML: Representation, paradox, and the 3rd directive. J of Money Laundering Control, 10(4), 412-428. doi:10.1108/1368520071083090

*served no real function beyond window dressing.*³⁰⁶ As a solution perhaps a quality framework for compliance needs to be developed further, so that banks can receive feedback on both the areas in which they are doing well and also receive support for the areas requiring improvement. By setting targets for improvement, units such as internal audit and governance can monitor the progress and ensure that resources are prioritised into these areas of development. This would encourage a longer term and more strategic approach to addressing AML deficiencies, something that other commentators have already advocated.³⁰⁷

2.2.2.1 TBML Risk Assessment

In order to provide an effective risk assessment process against trade based money laundering, it is also necessary to understand how money launderers actually use the financial services and present it in the banking context. The process of money laundering (ML) has traditionally been described as consisting of three key stages.³⁰⁸

- 1) Placing of illegally gained money into the banking sector,
- 2) Layering the money through a series of transactions including investments into other legitimate businesses,

³⁰⁶ O'Brien, J., & Dixon, O. (2013). Common link in failures and scandals at the world's leading banks, the. *Seattle University Law Review*, 19, p971

³⁰⁷ Neilsen, G., & Furneaux, W. (2013). Financial crime: Compliance and failure. Retrieved from <http://www.bankingtech.com/57881/financial-crime-compliance-and-failure>

³⁰⁸ McDowell, J., & Novis, G. (2001). The Consequences of Money Laundering and Financial Crime. *Economic Perspectives*, An Electronic Journal of the U.S. Department of State, 6(2), 3-.

- 3) Integrating it fully into the financial system as legitimate money which can be traced back through legal transactions to legitimate businesses and banks.

It is at each one of these stages that a bank selected by the launderers has the potential to play a role in facilitating or detecting that ML activity is taking place. However, even fairly recent reviews by the FCA have determined that this does not always happen and that despite the illegality of the crime, the FCA review in 2011 found that many banks were still unwilling to turn down a profitable business relationship even *“when there appeared to be an unacceptable risk of handling the proceeds of crime.”*³⁰⁹

2.2.3 Detecting TBML activity

In traditional cash based money laundering activity the easiest way to detect suspicious activity is at the beginning during the placement stage.³¹⁰ This is because the criminal is at his or her most vulnerable and is handling newly acquired illegal money, it is at this stage that the cash is at its dirtiest in the laundering process. However, the system for trade-based money laundering (TBML) is slightly different, since many of the transactions that are presented to the banks also involve or are merged

³⁰⁹ FSA. (2011). Financial Crime Newsletter. FSA.

³¹⁰ McDowell, J., & Novis, G. (2001). The Consequences of Money Laundering and Financial Crime. Economic Perspectives, An Electronic Journal of the U.S. Department of State, 6(2), 3-.

with legitimate business transactions ³¹¹ right from the beginning. Therefore, there is no starting point of really dirty money, the cash may be halfway through its cleaning cycle by the time it enters a financial institution. Some of the businesses that bring this money into the banking sector may either act as a front company for the criminals seeking to launder money, or they are legitimate criminal businesses that are already layering the money into the system from other crimes. Detection is therefore more complicated and requires significantly more information to be analysed and understood compared to normal ML transaction.

Once the money does enter the banking system a system of red flag alerts and regulation requirement checks are used, which is often referred to as a risk assessment approach.³¹² Traditionally this system has been designed as a 'rules based' approach whereby certain tick box criteria were met and ML checks were undertaken as part of a routine procedure. However, the evolving complexity of ML techniques has caused some to question the wisdom of continuing to use a one size fits all response ³¹³ especially since banks need to be constantly aware of emerging trends and increased levels of complexity within ML transactions.³¹⁴ As part of its guidance and recommendations FATF have promoted a 'risk based' approach ³¹⁵ rather than a rules based system. This they argue encourages banks to be more flexible and possibly more

³¹¹ FATF. (2008). Best practices paper on trade based money laundering. Paris: FATF/OECD. Available from: <http://www.fatf-gafi.org/> [accessed 11th May 2015].

³¹² Simser, J. (2012). Money laundering: Predicate crimes, laundering techniques and the AML response. Emerging Issues 6195: Matthew Bender & Company. Inc

³¹³ Soudijn, M. (2014). A Critical Approach to Trade-Based Money Laundering. Journal of Money Laundering Control Vol 17, Iss 2, 230-242.

³¹⁴ FATF. (2008). Best practices paper on trade based money laundering. Paris: FATF/OECD. Available from: <http://www.fatf-gafi.org/> [accessed 11th May 2015].

³¹⁵ FATF (2008)

thorough in their assessment processes. However, the disadvantage to this system is that it requires a greater level of understanding of TBML crime processes and needs more time to undertake the in-depth and thorough analysis of the data.

2.2.3.1 Current AML detection

On a practical level there are a number of AML measures that banks can, and regularly do implement as part of their AML regulatory and risk assessment processes, and all of these can be adapted for future or newer models that may be developed on AML or TBML risk assessment. The following section describes the main tools that banks currently use, at the end of each description a key point to be specifically applied to TBML risk assessment has been added in bullet point.

2.2.3.2 Customer Due Diligence (CDD)

The first of these measures is the customer due diligence (CDD) and enhanced due diligence (EDD) systems,³¹⁶ whereby client information and background account information are gathered. Clients need to satisfy a number of criteria before the bank is willing to work with them. However, from the information already ascertained in relation to TBML risk and in light of the newly proposed definition of TBML for banks, there is now one important element to be considered in the old AML system.

³¹⁶ Mugarura, N. (2014). Customer Due Diligence (CDD) mandate and the propensity of its application as a global AML paradigm. *Journal of Money Laundering Control*, 17(1), 76-95.

The increasing use of legitimate businesses as front companies is one way in which criminal syndicates have sought to circumvent many of the risk assessment processes.³¹⁷ This means that initial customer due diligence checks in these situations will show that the client documentation can be verified and be valid. However, it is at the second level of checks, seeking beneficial ownership that the bank can begin to unravel some of the deception. Other factors such as unusual business transactions for this client and sudden changes in transaction patterns can flag to the bank that something is amiss.

- CDD checks and EDD risk assessments are only effective if the information can be verified. If the information cannot be verified or raises suspicions this needs to be noted.

2.2.4 Beneficial Ownership Information (BOI)

This is not a regulatory requirement in all countries but it is becoming stronger in light of recent ML cases, especially in the US. Beneficial ownership information focuses on establishing who the actual benefactor of a business is, rather than the traditional approach of listing the named shareholders or shell companies that might be operating under that name. Beneficial ownership is seen as moving one step closer towards unravelling where financial transactions might be originating from

³¹⁷ FCA. (2013). Bank's control of financial crime risks in trade finance. London: Financial Conduct Authority.

or ultimately heading towards. Although banks might complain that this is another layer of paperwork,³¹⁸ perhaps from the new definition it is apparent that it might be a more cost effective process than other methods of verifying business transactions.

One of the challenges facing the banking sector is the achievability of such a request especially where companies have been legally registered in countries that have less stringent recording systems³¹⁹ and/or free trade zones.³²⁰ The FATF in its 2014 document on beneficial ownership and transparency³²¹ acknowledges that the actual owner could be through a chain of ownership, which makes the task of tracing the source even more complicated, it is also one of the reasons that the real estate sector³²² is popular amongst money launderers because chains of ownership are easy to set up and can become complex very quickly. This means that money moved into a country through TBML can then be moved straight into property investment, thus legitimising large sums of money in one transaction. The 4th EU Directive on Money Laundering³²³ in Article 13 also extends the requirement to establish the legal owner or to establish who has the ultimate control or controls the dominant power

³¹⁸ Pellegrina, L. D., & Masciandaro, D. (2008). The Risk Based Approach in the new European Anti-Money Laundering Legislation: A Law and Economics View. "Paolo Baffi" Centre Research Paper Series No. 2008-22, 1-24.

³¹⁹ Davilas, C. (2014). AML compliance for foreign correspondent accounts: A primer on beneficial ownership requirements and other challenges. *Journal of Investment Compliance*, 15(1), 4-16. doi:10.1108/joic-01-2014-0003

³²⁰ Shen, W., & Vanhullebusch, M. (2015). Where is the alchemy? The experiment of the shanghai free trade zone in freeing the foreign investment regime in china. *European Business Organization Law*

³²¹ FATF. (2014). Transparency and beneficial ownership. France: Financial Action Task Force. FATF Guidance.

³²² ESAAMLG. (2013). Typologies Report on Money Laundering Through the Real Estate Sector in the ESAAMLG Region. Namibia. Retrieved from [http://www.esaamlg.org/userfiles/file/TYPOLOGIES-REPORT-ON-ML-THROUGH-THE-REAL-ESTATE-SECTOR\(1\).pdf](http://www.esaamlg.org/userfiles/file/TYPOLOGIES-REPORT-ON-ML-THROUGH-THE-REAL-ESTATE-SECTOR(1).pdf)

³²³ Directive (EU) 2015/849 of the European Parliament and of the Council. (2015). [content/EN/TXT/PDF/?uri=CELEX:32015L0849&from=E](http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015L0849&from=E)

source of a company, however for this to be fully enacted all parties involved in registering companies and ownership need to be regulated, otherwise banks cannot access the data even if checks are run. These are some of the challenges that the Wolfsberg group has noted as part of their response to beneficial ownership requirements.³²⁴

There are however, inherent difficulties in BOI because it relies extensively on third party organizations to have collected the appropriate data. This is especially noticeable in free trade zones where legal entities can be established relatively easily and with minimal checks of ownership or intent.

Determining beneficial ownership can become a banking priority over checks of shipping and lading information, since the latter can all be falsified and would need the support of agencies such as customs and exercise in order to verify accurately.

2.2.5 Multiple Banking Partners

A final risk assessment area that is often used, is to check the AML requirements of partner banks i.e. external banks that might be involved in the transaction. However, it is possible that other banks have perfectly good AML requirements, and if they do not then ironically enough they will

³²⁴The Wolfsberg Group. (2012). The wolfsberg AML principals frequently asked questions with regards to beneficial ownership in the context of private banking. Retrieved from <http://www.wolfsberg-principles.com/pdf/faq/Wolfsberg-FAQs-on-Beneficial-Ownership-May-2012.pdf>

be more vulnerable to easier methods of transporting cash rather than using TBML transactions. Instead the very fact that multiple banks are involved should be a trigger in its own right, but again the assessment should be made against the overall business viability of the client's company.³²⁵

Checking the anti money laundering compliance of partner banks i.e. external banks that might be involved in the transaction is a useful risk assessment tool. AML regulations are issued by oversight bodies such as FINRA in the United States, and the HMRC in the United Kingdom. Consequently, one country's AML regulations can be quite different from another's. Differences can be so distinct that PWC felt compelled to issue a guide detailing the differences between the AML regulations and environment of 74 countries.³²⁶

Different geographical locations will have different rules and regulations in place, attitudes to AML requirements also differ. Take for instance a coffee producer who uses a local Kenyan bank and supplies a UK coffee chain which uses a London-based bank. Both banks will have varying policies and varying frameworks, and as such when the paperwork looks in order to the Kenyan bank it is dispatched to the UK bank for payment. Both banks must ensure, in such instances, that each understands what the other's AML regulations are, how they are applied

³²⁵ Pwc (2012) Know your customer quick reference guide. Retrieved from: <https://www.pwc.com/gx/en/financial-services/assets/pwc-kyc-anti-money-laundering-guide-2013.pdf>

³²⁶ Pwc (2012) Know your customer quick reference guide. Retrieved from: <https://www.pwc.com/gx/en/financial-services/assets/pwc-kyc-anti-money-laundering-guide-2013.pdf>

and what measures apply to the specific transaction, before payments are made.

The differing approaches to AML are most obvious between certain types of banking systems. More technologically based systems will have money-laundered through, for instance, the purchase and re-sale of expensive goods; in cash-cultures, such as the Middle East and Africa, the physical movement of the cash is the predominant means of laundering it.³²⁷

Naturally, it is most likely that partner banks have AML requirements that match those of the other partner banks, in these cases membership of the FATF (Financial Action Task Force) would be a good indicator. The FATF is a voluntary inter-governmental agency, whereby member countries co-operate on the development and enforcement of AML and terrorist financing regulations. Banks and countries that are not members, or who fall short of the agreed norms, (these reports can be easily downloaded from the FATF website), are more vulnerable to easier methods of transporting cash compared to TBML (Trade-Based Money Laundering) and so, ironically, suffer less money-laundering activity as a consequence. It follows that multi-bank, trans-national transactions should be analysed more carefully for AML regulatory compliance (from the perspective of both countries) than those involving only one bank.

³²⁷ Lewis, E & Yusuf, A (2011) Anti-money laundering challenges. Retrieved from <https://www.financierworldwide.com/anti-money-laundering-challenges/#.WKsGFNKLTI>

However, it is a typical Venn diagram: whilst the majority of multi-bank, bi-national transactions fully comply with AML regulations and are not vehicles for money laundering or terror finance, the vast majority of transactions that involve money laundering and trade based money laundering are multi-bank, bi-national transactions. This is because the gaps in technological capacity, cultural differences and varying interpretations of AML regulations make it that much harder to track or trace laundering activity. It is therefore simply useful to flag these types of transactions for particular attention when auditing for AML compliance, as they are ideal vehicles for laundering, and more recently, terror finance. A final note on AML regulations: in terms of the risk management of inter-country transactions, the final assessment should be made against the overall business viability of the client's company.

Transactions involving multiple banks should trigger a system of checks that seek to establish the overall viability of the business, rather than focusing only on the area that funding is sought for. In this assessment system, which doesn't have to be too detailed, the following points should be considered:

- Is there an undue amount of complexity involved in the shipping and movement of goods?
- Are there sound business reasons for choosing the export countries and shipping routes?
- Would a normal business transaction of this nature make the expected financial returns that the client is predicting or showing has happened?

- Could this business achieve the same expected outcomes using illegal goods, laundered money or falsified information at any stage?

2.3 Red Flags

FATF (2006, 2008) in both its reports on trade-based money laundering has recommended implementing a system of red flag alerts, that should warn banking personnel about the possibility of TBML activity. These red flags have been developed from studies and typologies from TBML situations that have been discovered so far. However, some researchers such as Soudijn³²⁸ are critical of the current red flag alert system. Soudijn maintains that the approach of FATF is fairly 'tunnel visioned' towards over and under invoicing as the main means of conducting TBML transactions. However, in his research with Dutch law enforcement officials he discovered that other methods for TBML activity were equally used and would not have been detected using the red flags focused on misinvoicing. Two other red flag areas that he suggested could also be included were a) spotting large amounts of cash deposits often in lower denomination notes entering into the banking system, and b) sudden changes in business type, such as a company that usually ships machinery suddenly dealing in rice. Soudijn's (2014) main criticism of the definition and understanding of TBML adopted by FATF, is the lack of

³²⁸ Soudijn, M. R. J. (2014). A critical approach to trade-based money laundering. *J of Money Laundering Control*, 17(2), 230-242. doi:10.1108/jmlc-01-2013-0001.
Zdanowicz, J. S. (2009). Trade-Based money laundering and terrorist financing. *Review of Law & Economics*, 5(2). doi:10.2202/1555-5879.1419

empirical data supporting the claims that misinvoicing is the main method for detecting TBML activity.

One researcher who has examined TBML activity in more detail is Stack ³²⁹ who has been following some of the Baltic money laundering schemes ³³⁰ where trade has been used as a component in the process. He maintains that organised criminal gangs engaged in money laundering have developed sophisticated illicit trading platforms, often in collusion with financial institutions and other professionals. These ML platforms comprise of a series of shell and front companies, with collaborative banks that help to distort the transactions and '*systematize misinvoicing*.' ³³¹ Although many developed countries may not face the same challenges as the Baltic States ³³² the reality of organised gangs, having support from some financial institutions and operating large scale sophisticated money laundering platforms, is a situation that will affect both developed and emerging economies at some point.

Studies following illicit trade ³³³ recognise that the increased stability of developed economies provides a better opportunity to retain and grow illicit funds. Therefore, illicit money moves from where it has been taken from, in the developing economies and moves into the more stable area of

³²⁹ Stack, G. (2015). Baltic shells: On the mechanics of trade-based money-laundering in the former soviet space. *Journal of Money Laundering Control*, 18(1).

³³⁰ Kar, D., & Freitas, S. (2013). Russia illicit financial flows and the role of the underground economy. *Global Financial Integrity*

³³¹ Stack, G. (2015). Baltic shells: On the mechanics of trade-based money-laundering in the former soviet space. *Journal of Money Laundering Control*, 18(1) p3

³³² Stack, G. (2015) "Money laundering in Ukraine: Tax evasion, embezzlement, illicit international flows and state capture", *Journal of Money Laundering Control*, Vol. 18 Iss: 3, pp.382 - 394.

Stack, G. (2015) "Shell companies, Latvian-type correspondent banking, money laundering and illicit financial flows from Russia and the former Soviet Union", *Journal of Money Laundering Control*, Vol. 18 Iss: 4, pp.496 – 512.

³³³ Kar, D., & Spanjers, J. (2014). Illicit financial flows from developing countries 2003-2012

developed economies³³⁴ and into formal banking institutions. Sometimes instead of cash the equivalent value is moved in the form of illicit or smuggled goods³³⁵ or it may be derived from illegal activities such as bribery and corruption.³³⁶ This not only removes money from weaker economies and countries that need it, but it also gives financial control of a country over to the criminals, which can cause or increase political instability within a region.³³⁷ At some point this money will inevitably enter financial institutions in the Western hemisphere or in off shore accounts or in other developed countries. “*GFI research suggests that about 45% of illicit flows end up in offshore financial centers, and 55% in developed countries,*”³³⁸ since this is the safest way to store large amounts of money.

2.3.1 TBML Patterns - Red Flag Alerts

Despite the reservations of some experts,³³⁹ red flag alerts still remain the main tool available for TBML risk assessment. From the descriptions and cases provided in this research so far it can be seen that there are a number of ways in which TBML can occur³⁴⁰ and these can be

³³⁴Kar & Spanjiers (2014)

³³⁵Basu, G. (2014). Concealment, corruption, and evasion: A transaction cost and case analysis of illicit supply chain activity. *Journal of Transportation Security*, 7(3), 209-226

³³⁶Julius Otusanya, O., Omobola Ajibolade, S., & Olajide Omolehinwa, E. (2011). The role of financial intermediaries in elite money laundering practices: Evidence from Nigeria. *Journal of Money Laundering Control*, 15(1), 58-84

³³⁷McDowell, J., & Novis, G. (2001). The consequences of money laundering and financial crime. *Economic Perspectives*, An Electronic Journal of the U.S. Department of State, 6(2)

³³⁸<http://www.gfintegrity.org/issue/illicit-financial-flows/>

³³⁹Zdanowicz, J. S. (2009). Trade-Based money laundering and terrorist financing. *Review of Law & Economics*, 5(2). doi:10.2202/1555-5879.1419

³⁴⁰Sullivan, C., & Smith, E. (2011). Trade based money laundering- risks and regulatory responses. Australia: Australian Institute of Criminology. Retrieved from http://aic.gov.au/media_library/publications/rpp/rpp115.pdf

seen in the typology studies.³⁴¹ Despite the simplicity of some of the case studies³⁴² in most cases trade based money laundering is not a simple process and often several money laundering techniques can be used at the same time.³⁴³

Trade misinvoicing³⁴⁴ is the most common way that TBML crimes are currently detected and this form of activity might be represented through a number of different schemes, including:

- Price misrepresentation (over or under invoicing).
- Fictitious invoicing (for goods that don't exist).
- Multiple invoicing.
- Falsely describing goods or misrepresenting the quality or quantity of goods.
- Legitimate shipment of goods between criminal groups.
- Ghost or phantom shipments (paperwork exists but goods were never moved).
- Disguising laundered funds as consultancy or other service related fees.
- Using free trade zones to unload and reload goods and disguise the initial port of loading.

³⁴¹ APG Typology Report on Trade Based Money Laundering. (2012). Sydney: Asia Pacific Group on Money Laundering

³⁴² AUSTRAC. (2013). Typologies and case studies report 2013. Australia: AUSTRAC Retrieved from http://www.austrac.gov.au/sites/default/files/documents/typ13_full.pdf

³⁴³ AUSTRAC. (2013). Typologies and case studies report 2013. Australia: AUSTRAC Retrieved from http://www.austrac.gov.au/sites/default/files/documents/typ13_full.pdf

³⁴⁴ Yalta, A. Y., & Demir, I. (2010). The extent of trade mis-invoicing in turkey: Did post-1990 policies matter?

Other techniques for moving money that have been discovered can also include abuse of the financial services in either the client's country, or in other countries where trading partners of the client are in operation:³⁴⁵

- Cuckoo smurfing³⁴⁶ & Smurfing³⁴⁷ funds (structuring funds into smaller amounts – **see Figure 1 on Page148**).
- Using investment and retail property to disguise the source of dirty money.
- Disguising the true beneficial owner of a company or business (through shell companies or front companies)
- Using false businesses or companies to receive or export goods.
- Using false identification and documentation for clients.

³⁴⁵ AUSTRAC. (2014). Typologies and case studies report. Australia: AUSTRAC. Retrieved from <http://www.austrac.gov.au/sites/default/files/typologies-report-2014.pdf>.

APG Typology Report on Trade Based Money Laundering. (2012). Sydney: Asia Pacific Group on Money Laundering.

AUSTRAC. (2013). Typologies and case studies report. Australian Transaction and Analysis Centre. Retrieved from http://www.austrac.gov.au/sites/default/files/documents/typ13_full.pdf

³⁴⁶ 'Cuckoo Smurfing' is an advanced form of smurfing whereby the knowledge of legitimate accounts, and transactions are hijacked by criminals for money laundering purposes, without the account holders' knowledge. This system has been compared to the activity of the cuckoo bird, which sneaks its eggs into other birds' nests and lets them hatch and rear its offspring. The criminal gang uses the knowledge of legitimate accounts and transactions and hijacks this information for money laundering purposes, without the account holders' knowledge. No money is taken from the account holder but the knowledge of the type and amount of a transaction is hijacked for the criminals to alter to suit their own means. Usually this entails diverting legitimate money in the middle of a trading transaction and replacing it with dirty money.

³⁴⁷ Smurfing: One of the ways that criminals can overcome some of the reporting regulation, is by using external allies to circumvent restrictions on deposit amounts or add confusion to the financial trail. The classic method is to take a large cash sum for example \$100,000 and to break this down into smaller sums of between \$8,000 - \$9,000. A number of members of the gang or outside members such as family or friends, are given batches of the money and ordered to deposit it from different banks locally, to arrive at the same destination bank. This process is known as smurfing and it was devised to avoid detection when large sums of cash needed to be deposited (Egmont Group. (2000). FIU's in action. 100 cases from the Egmont Group). However, as banks have become more aware of this process other more complex smurfing activities have been developed (FATF. (2006). Trade based money laundering. France. Financial Action Task Force).

- Naming family members and relatives as directors of the companies and businesses.³⁴⁸
- Using third party countries and companies to complicate trading routes making it harder to follow the shipment and goods.

All of the above mentioned points can also act as indicators of suspicious activity if they are discovered or suspected.

³⁴⁸ The Glossary to the FATF 40+9 Recommendations describe PEPs as “individuals who are or have been entrusted with prominent public functions in a foreign country, for example heads of state, or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations [and] important political party officials ... The definition is not intended to cover middle ranking or more junior individuals in the foregoing categories.”, FATF., 2011. Laundering the proceeds of corruption. Vancouver. Source: www.fatf-gafi.org/media/fatf/documents/reports/Laundering%20the%20Proceeds%20of%20Corruption.pdf
 Raymond Choo, K.K., 2008. Politically exposed persons (PEPs): risks and mitigation. Journal of Money Laundering Control, 11(4), pp.371-387.

“Corrupt PEPs may seek to engage the services of one or more close associates (or possibly more distant family members with dissimilar names), to disguise their own interests. Using trusted close associates, many of whom do not appear on commercial databases, reduces the likelihood that financial institutions will recognise the PEP association, and institute enhanced due diligence.”
 Source : <http://www.aperio-intelligence.com/identifying-close-associates-of-politically-exposed-persons-peps/>

Greenberg, T.S., Gray, L., Schantz, D. and Latham, C.G.M., 2010. Politically Exposed Persons. Preventive Measures for the Banking Sector. Washington: The World Bank.

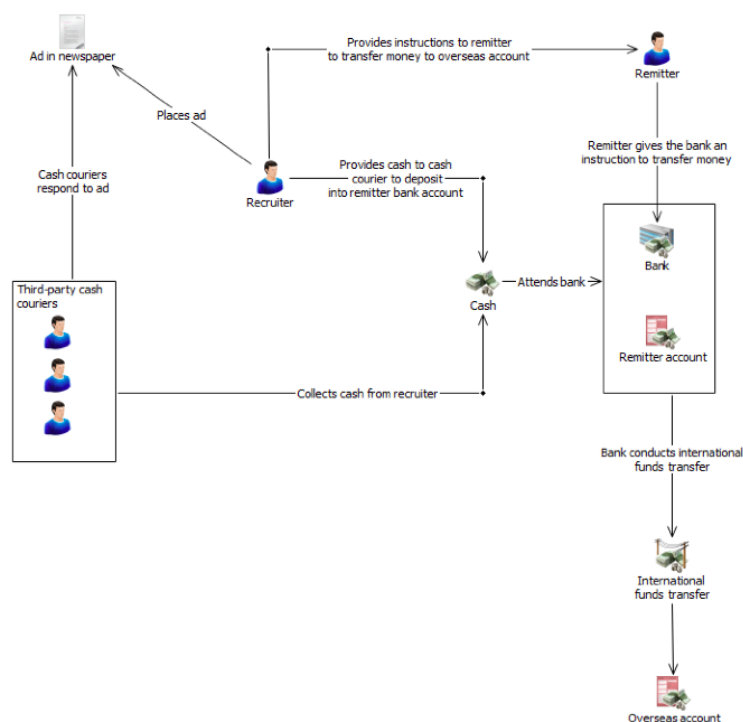


Figure 1 - Example of smurfing activity reproduced from AUSTRAC (2014, p77)

2.3.2 Use of Data Technology in Risk Assessment

Despite the simplicity of a red flag system, it still tends to rely on the physical detection of suspicious activity by trained personnel, primarily because the analysis of data and the technology required to support this type of assessment is still being developed. Recent discoveries of ML cases by law enforcement and the banking sector have highlighted the levels of complexity that exist in money laundering schemes, which in turn has led to the recognition of a number of specific areas of money laundering activity such as trade based money laundering. In response to

this recognition there has been a slow development in technology and software to support AML officers in their work. These developments include software designed as web-crawling tools, such as trade finance algorithms that could be developed to capture all shipping related documentation that banks could use. PWC³⁴⁹ outline two basic methods in which software can be used in TBML detection; firstly, text analysis to identify specific words, numbers or phrases such as customer names or certain product types, and secondly web analytics which can compare actual shipping details against the documentation being submitted. Other technologies such as AML sanctions software are available to enable banking staff to follow news reports of different countries.³⁵⁰ Of most importance to TBML detection is perhaps the work in the US on trade data comparisons.

2.3.3 Use of Trade Data Technology

It is recognised at this stage that the amount of information that has to be processed to satisfy AML regulation and risk assessment is considerable.³⁵¹ The use of technology and in particular the programmes required to analyse large data projects will become increasingly common in the financial services sector.

*“Technology is essential for fulfilling regulatory requirements
and gathering customer knowledge, not just to fix short-term*

³⁴⁹ PwC. (2014). Goods gone bad. Addressing money-laundering risk in the trade finance system.

³⁵⁰ PwC. (2014). Goods gone bad. Addressing money-laundering risk in the trade finance system.

³⁵¹ Neilsen, G., & Furneaux, W. (2013). Financial crime: Compliance and failure. Retrieved from <http://www.bankingtech.com/57881/financial-crime-compliance-and-failure>

*issues but doing so in a manner flexible enough to meet future requirements.*³⁵²

The challenge that software developers and the banking profession both face is to determine what data needs to be analysed and for what purpose. As trade data analyst Chris Bingham a CEO for a data analysis software company said in an interview *“For us, in particular, there’s been a tremendous amount of hype around Big Data, and people realize that data by itself is just that, an enormous pile of data. Unless you have the right tools, visualizations, processes and applications to turn that data into insights and then actions, it’s just a bunch of data.”*³⁵³

Is it possible to justify each bank engaging in this level of investment for AML software and training or should other systems such as that suggested by McCarthy, van Santen, & Fiedler, (2014) be considered? They proposed the need to establish an international intelligence database to increase the effectiveness of sharing and communicating information across jurisdictions. However, this would also require a high level of inter-agency cooperation and communication, and this might pose challenges for institutions and domestic legislation that are not designed to operate in this manner.

³⁵² Nielsen, G., & Furneaux, W. (2013)

³⁵³ Nicole, K (2015) Why content doesn't matter to this data mining business <http://siliconangle.com/blog/2015/03/03/why-content-doesnt-matter-to-this-data-mining-business/> accessed 7 March 2015

2.3.4 Trade Transparency Units

There have been some developments on the academic and research side towards developing a trade database using US trading data. In the US model, the use of trade data analysis has been proposed as one way in which law enforcement and customs officials can thwart price alterations and changes to weights of shipments.³⁵⁴ In the work undertaken by Zdanowicz³⁵⁵ using US Trade data, Zdanowicz monitored bi-lateral trade transactions into and out of the US. He looked at trade disparities and pricing anomalies compared to international trading prices. He discovered obvious suspicious trading prices were in operation such as the following examples:

³⁵⁴FCA. (2013). Bank's control of financial crime risks in trade finance. London: Financial Conduct Authority.

³⁵⁵Zdanowicz, J. S. (2009). Trade-Based money laundering and terrorist financing. *Review of Law & Economics*, 5(2). doi:10.2202/1555-5879.1419
Sullivan, C., & Smith, E. (2011). Trade based money laundering- risks and regulatory responses. Australia: Australian Institute of Criminology. Retrieved from http://aic.gov.au/media_library/publications/rpp/rpp115.pdf

Table 1: U.S. Exports at Low Averages Prices

Product Country	Country	Average Price	World Average Price
Cooking Stoves	Colombia	\$ 76.62/unit	\$ 425.65/unit
Erythromycin	Iran	\$ 0.10/gram	\$ 1.20/gram
Nickel Alloy Wire	Venezuela	\$ 2.21/kg	\$ 12.26/kg
Herring-Bone Tire	France	\$ 7.69/each	\$ 192.25/unit
Machine Guns	France	\$ 364.08/unit	\$ 2,022.67/unit
Enriched Uranium ²³⁵	Spain	\$ 15.50/kg	\$ 172.22/kg
Military Rifles	UK	\$ 106.87/unit	\$ 387.55/unit

Based on these findings Zdanowic declared that it should be possible to categorise trading patterns using a percentile of the results, i.e. a broad pattern that covered normal trading discrepancies. He then stated that any prices that fell out of this normal pattern of data could be deemed as suspicious.

Using these results Zdanowicz³⁵⁶ developed a model that focused on four key areas of data interest that customs and excise could monitor:

1. Country risk profiles,
2. Customs district risk profiles,
3. Product risk profiles and
4. Transaction price risk profiles.

Zdanowicz's work was based solely on US bi-lateral studies however other research into bilateral trade statistics such as work undertaken by

³⁵⁶Zdanowicz, J. S. (2009). Trade-Based money laundering and terrorist financing. *Review of Law & Economics*, 5(2). doi:10.2202/1555-5879.141

Yalta & Demir, (2010) on Turkey, show that TBML is country specific depending on which direction the value is moving. Patterns of trade data discrepancies for countries are therefore either reported using over invoicing or for movement in the other direction countries would be using trade under invoicing.

Since this information is often collected by different agencies at different points in the trading process there was a strong need to share data across agencies and increase interagency co-operation.³⁵⁷ This interagency sharing of data was facilitated through a Trade Transparency Unit. The introduction of Trade Transparency Units in the US, now offers one example of an interagency model to illustrate how co-operation and sharing of trade data can benefit those working to combat TBML transactions.³⁵⁸

2.3.5 Challenges of Trade Data Comparisons

Trade data can be a useful tool where obvious discrepancies arise from deliberate criminal manipulation of the trade process, however in order to compare data the destination and source countries need to be known. There are therefore additional complications to be overcome when using bilateral trade statistics as highlighted by Berger & Nitsch (2008), such as verifying the actual source country, rather than the last port of departure. Another problem is ensuring that the corresponding trade data is recorded in the same calendar year particularly for shipments near the end

³⁵⁷ FCA. (2013).

³⁵⁸ Zdanowicz, J. (2009). Trade Based Money Laundering and Terrorist Financing. Review of Law and Economics Vol 5 No.2, 855-878.

of the year, and that the valuation of goods are similar and tally across both countries.³⁵⁹ Other factors that trade data can overlook include the exchange rates “a real depreciation of the exchange rate affects the level of import under invoicing only but not the other types of trade misinvoicing.”³⁶⁰

In reality most TBML cases, either for money laundering or tax evasion are currently uncovered through manual spot checks by customs and excise, as goods are being unloaded. This was the case in Ireland in 2012 when a business man involved in tax evasion was caught for falsely declaring the contents of the shipping container.

*“....the scam was uncovered on 9 October, 2007 when customs officers at Dublin Port investigated a container that was supposed to contain 18 tonnes of apples and two tonnes of garlic. When they looked inside they found 21 tonnes of garlic and no apples. Officer Twohig said the import duty on apples is 9% while the duty on garlic is €120/kg and 9.6% of the total value. The outstanding tax on this consignment alone was €25,000.”*³⁶¹

³⁵⁹ Berger, H., & Nitsch, V. (2008). Gotcha! A profile of smuggling in international trade. In CESIFO WORKING PAPER NO. 2475. Presented at CESIFO Venice Summer Institute 2008, WORKSHOP ON ‘ILLCIT TRADE AND GLOBALISATION’: CESifo Working Paper Series

³⁶⁰ Buehn, A., & Eichler, S. (2011). Trade misinvoicing: The dark side of world trade. The World Economy, 34(8), P1284

³⁶¹ RTE (2012) Six-year sentence for €1.6m garlic scam <http://www.rte.ie/news/2012/0309/314490-begleyp/> accessed 25 February 2015

The point being here is that you need an actual customs check to verify the goods stated on any trade invoice, which also applies to money laundering situations especially TBML.

Studies from the Global Financial Integrity organization who monitor global trends in illicit trade flows, suggest that the easier trade transactions to measure are those of misinvoicing of goods, such as Zdanowicz's system.³⁶² However, this means that trade misinvoicing in services, same invoice trade misplacing, Hawala and informal financial sector transactions as well as bulk cash transactions are not included in the overall TBML picture at the moment, therefore more sophisticated measuring system do need to be developed.

2.3.6 Implications for the Banking Sector

The bulk of this work within the banking sector is usually undertaken through the AML compliance unit within the bank, however, other areas of the bank would benefit from acquiring a level of understanding about money laundering and TBML activity, such as trade finance and audit. In particular, the role of internal audit, which to date has been largely ill defined within this complex and regulatory led process, could develop a level of expertise in order to monitor AML compliance more effectively within the bank.

³⁶²Zdanowicz, J. S. (2009). Trade-Based money laundering and terrorist financing. *Review of Law & Economics*, 5(2). doi:10.2202/1555-5879.141.

Kar, D., & LeBlanc, B. (2013). *Illicit financial flows from developing countries 2002-2011*.

2.4 Internal Audit

The internal audit function (IAF) is often considered as the main control mechanism that supports management ³⁶³ and is part of the overall governance system. The COSO definition for internal control states that *“internal control is broadly defined as a process, affected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding achievement of effectiveness and efficiency of operations, reliable financial reporting, and compliance with applicable laws and regulations.”*³⁶⁴ However, the role of internal control within AML compliance is often less easily defined, and this lack of clarity has been recently criticised by financial regulators.³⁶⁵

Although internal audit might be considered an integral part of banking governance it was not actually until the 1940s that it began to become a professional discipline recognised within management.³⁶⁶ The current definition of internal audit as outlined by the IIARF, sees its role as an independent and objective mechanism to add value and assurance to the overall governance process.

“Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an

³⁶³ Mihret, D. G. (2014). How can we explain internal auditing? The inadequacy of agency theory and a labour process alternative. *Critical Perspectives on Accounting*, 25(8), 771-782. doi:10.1016/j.cpa.2014.01.00

³⁶⁴ Altamuro, J., & Beatty, A. (2010). How does internal control regulation affect financial reporting? *Journal of Accounting and Economics*, 49(1-2), 58-74 (p60)

³⁶⁵ FCA. (2013). Bank’s control of financial crime risks in trade finance. London: Financial Conduct Authority.

³⁶⁶ Castanheira, N., Lima Rodrigues, L., & Craig, R. (2009). Factors associated with the adoption of risk-based internal auditing. *Managerial Auditing Journal*, 25(1), 79-98. doi:10.1108/02686901011007315

*organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.*³⁶⁷

However, for internal audit to be viewed as effective it must also possess an “*appropriate level of quality*.”³⁶⁸ One of the challenges that internal audit faces lies in that definition of quality, since the question really is, who defines quality and who ensures that it has been achieved. Internal Audit is designed to serve multiple clients including the audit committee and management.³⁶⁹ It also offers both assurance and consulting services, which could be viewed as contradictory roles for one function to cover.³⁷⁰ Reporting on AML compliance could also be considered as another contradictory role since it runs the risk of criticising the group that provides resources for its work, which could either be the audit committee or governance. Avianti's (2009) definition of quality is therefore very subjective when considering the role of internal audit.

³⁶⁷ PWC (2015) Internal Audit Services <http://www.pwc.com/id/en/internal-audit-services/index.jhtml>

³⁶⁸ Avianti, I. (2009). Relationship between internal audit function, audit committee and management reporting (A literature study in corporate governance implementation). Unpublished Working Paper. Department of Accounting, Padjaran University p2

³⁶⁹ Abbott, L. J., Parker, S., & Peters, G. F. (2010). Serving two masters: The association between audit committee internal audit oversight and internal audit activities. *Accounting Horizons*, 24(1), 1-24. doi:10.2308/acch.2010.24.1.1

³⁷⁰ Lenz, R., & Sarens, G. (2012). Reflections on the internal auditing profession: What might have gone wrong? *Managerial Auditing Journal*, 27(6), 532-549. doi:10.1108/02686901211236382

2.4.1 Role of Internal Audit in AML

Part of the role of internal audit is to report to the audit committee³⁷¹ on the effectiveness of AML compliance systems being used in the bank.³⁷² Currently this seems to be done in a tick box format as to whether systems are in place and to appease the audit committee³⁷³ as opposed to assessing whether effective systems are being used.³⁷⁴ This system is unlikely to change until IAF becomes more skilled in AML auditing and banks introduce specific AML auditing and reporting criteria that guide how audit committees require data to be analysed and presented to them. The weakness of IAF in this regard are highlighted in the lack of skills available to identify a strong AML compliance system and to offer an evidence based assessment of what is and is not working well within the unit.³⁷⁵

2.4.2 An Independent Role for the IAF

If maintaining independence and objectivity is not a realistic option for most IAF, since they are too closely aligned or integrated into the overall governance structure, perhaps a broader and more independent

³⁷¹Avianti, I. (2009). Relationship between internal audit function, audit committee and management reporting (A literature study in corporate governance implementation). Unpublished Working Paper. Department of Accounting, Padjaran University

³⁷²PWC. (2014). Internal audit holding the line on BSA/AML compliance. Retrieved from <http://antimoneylaundering-fiba.com/files/1499.pdf>

³⁷³Norman, C. S., Rose, A. M., & Rose, J. M. (2010). Internal audit reporting lines, fraud risk decomposition, and assessments of fraud risk. *Accounting, Organizations and Society*, 35(5), 546-557.

³⁷⁴Lenz, R., & Sarens, G. (2012). Reflections on the internal auditing profession: What might have gone wrong? *Managerial Auditing Journal*, 27(6), 532-549. doi:10.1108/0268690121123638

³⁷⁵Pickett, S. (2000). Developing internal audit competencies. *Managerial Auditing Journal*, 15(6), 264-265

role is needed, especially in relation to AML and compliance. Such a role could see internal audit acting as a link between different banks through a regional audit committee, rather than answerable at a smaller branch level. This might overcome some of the issues raised in the global internal audit report ³⁷⁶ where internal audit was struggling to find recognition with governance because many governance issues are outside the remit and focus of IAF and this hampers communication and an understanding of the issues affecting IAF within governance and local audit committees. This could facilitate the transfer of information to financial intelligence units as well as ensure compatibility across all branches in a region, which could then be connected globally. In his analysis of IAF and the relationships with regulators, Andrew's ³⁷⁷ points out that both Basel and the UK guidelines provide opportunities for direct engagement between regulators and internal auditors, and so directly engaging with a regional audit body or FIU would be in a similar role.

It ensures that the primary role of IAF is there to support and enhance the work of management but is answerable externally to the local regional audit office. There are many challenges to this approach not least logistics and practical reporting and communication issues. There is also an identified problem of skill level and requirements within internal audit function, especially the lack of investigative skills in areas of fraud and financial abuse, as some researchers have highlighted.³⁷⁸

³⁷⁶ CBOK. (2014). Internal audit around the world - A perspective on global regions. Florida: The Institute of Internal Auditors Research Foundation

³⁷⁷ Andrew, A. (2014). Guidance on internal audit's interface with regulators: An analysis and appraisal of recent developments. *Managerial Auditing Journal*, 29(3), 268-283

³⁷⁸ Chambers, A. D., & Odar, M. (2015). A new vision for internal audit. *Managerial Auditing Journal*, 30(1), 34-55

2.4.2.1 Assessing Effectiveness in IAF

At this stage the challenge is to begin to think outside the traditional audit box, and begin to streamline audit function across branches. Industry reports such as PwC ³⁷⁹ have also emphasized that it is important that internal audit does not lose its function and can continue to operate effectively as the international and global banking context continues to evolve specifically with AML compliance. One of the ways for IAF to maintain its importance and relevance is to ensure that the system for measuring its effectiveness is updated and is also using the appropriate outcomes and key performance indicators. This is especially important given the ongoing evolvement of the IAF role ³⁸⁰ in response to changes in business and banking generally as well as AML and compliance.

2.4.2.2 Links to External Audit

As mentioned earlier a key component of the IAF is to assume a position of independence and objectivity from the rest of the banking units.³⁸¹ The quality of independence of the IAF is usually assessed from the perspective of the external auditor,³⁸² who is also supposed to be

³⁷⁹ PwC (2015b) Internal Audit Services <http://www.pwc.com/id/en/internal-audit-services/index.jhtml>

³⁸⁰ Coetzee, P., & Lubbe, D. (2013). Improving the efficiency and effectiveness of risk-based internal audit engagements. *International Journal of Auditing*, 18(2), 115-125. doi:10.1111/ijau.12016

Soh, D. S., & Martinov-Bennie, N. (2015). Internal auditors' perceptions of their role in environmental, social and governance assurance and consulting. *Managerial Auditing Journal*, 30(1), 80-111. doi:10.1108/maj-08-2014-1075.

³⁸¹ PwC (2015b) Internal Audit Services <http://www.pwc.com/id/en/internal-audit-services/index.jhtml>

³⁸² Avianti, I. (2009). Relationship between internal audit function, audit committee and management reporting (A literature study in corporate governance implementation). Unpublished Working Paper. Department of Accounting, Padjaran University

providing an independent and objective assessment. This has often led to an overlap in function and roles between developing the external and internal audit reports, and in some cases internal audit has contributed to a significant amount of the preparation of the external audit report.³⁸³ This is despite several recommendations after the financial crisis,³⁸⁴ including the UK House of Lords report that internal audit is separate and should not be outsourced and should work independently to external audit companies.³⁸⁵

The problem though is the increasing cost of compliance and regulation, which is causing many smaller banks to reconsider whether IAF is a function that they can fund full time and whether there are sufficient skills³⁸⁶ in house to maintain this function. If the requirements for IAF continue to increase it may no longer be an economical option to retain internal audit function within the organization. This may provide another option to centralize IAF expertise³⁸⁷ through a regional AML regulatory committee that can supply expertise to banks of AML risk and AML audit reporting.

³⁸³ Abbott, L. J., Parker, S., & Peters, G. F. (2010). Serving two masters: The association between audit committee internal audit oversight and internal audit activities. *Accounting Horizons*, 24(1), 1-24. doi:10.2308/acch.2010.24.1.1

³⁸⁴ Abbott, L. J., Parker, S., & Peters, G. F. (2010). Serving two masters: The association between audit committee internal audit oversight and internal audit activities. *Accounting Horizons*, 24(1), 1-24. doi:10.2308/acch.2010.24.1.1

³⁸⁵ House of Lords Report (2011) Auditors: Market Concentration and their Role, Vol. 1, HL paper 119-II, op cit, pp. 281-282, Q380

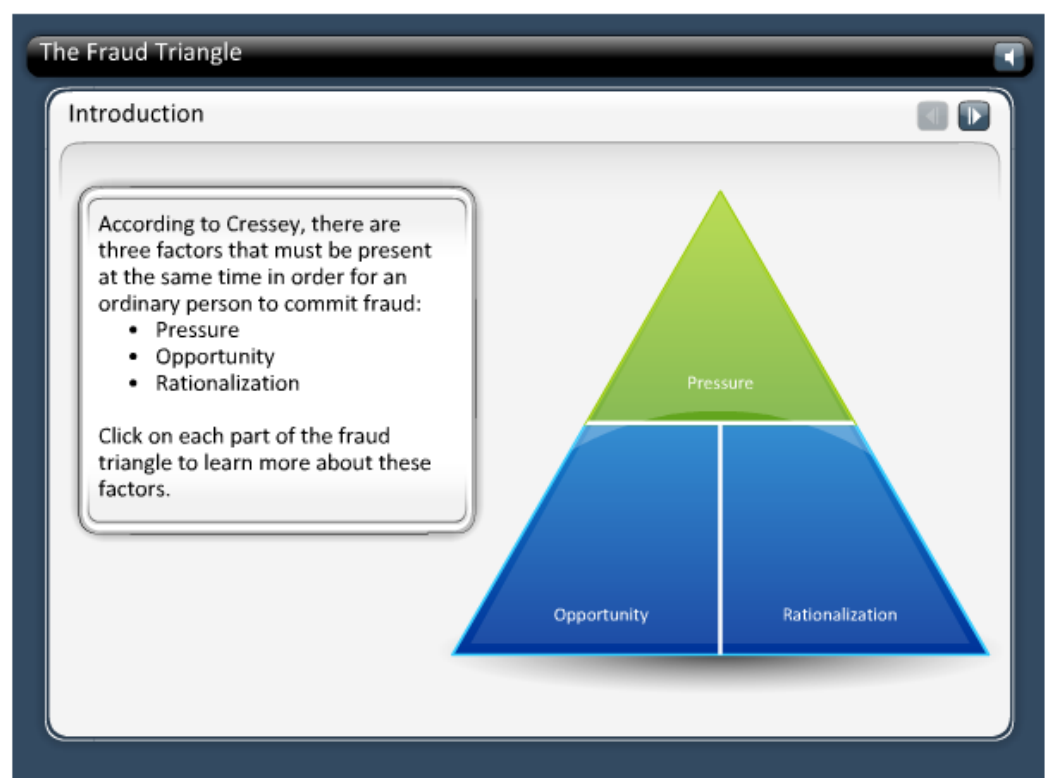
³⁸⁶ Pickett, S. (2000). Developing internal audit competencies. *Managerial Auditing Journal*, 15(6), 264-265

³⁸⁷ Chambers, A. D., & Odar, M. (2015). A new vision for internal audit. *Managerial Auditing Journal*, 30(1), 34-55.

2.4.2.3 IAF and AML Risk Assessment

The focus of IAF reform has tended to have been influenced by the recent financial crisis ³⁸⁸ and the exposure of banks to risk taking and managing their own investments.

This is a different focus to looking at AML risk and audit within the banking context. One of the main differences is that the prevention of crime and risk assessment is developed across a number of different functions within the bank. Criminals will take any opportunity to infiltrate a system and this could be through trading, front office staff or business and investment.



³⁸⁸Chambers, A. D., & Odar, M. (2015). A new vision for internal audit. *Managerial Auditing Journal*, 30(1), 34-55.

Above ³⁸⁹ highlighted in diagram form, is how criminal opportunity strikes in relation to fraud and the possibility of targeting specific members of staff within the bank, with the main factors being opportunity, pressure and rationalization. But the diagram could equally illustrate the factors impacting on money laundering and the gaps in any AML system that need to be filled by the governance and banking units.

Part of a revised role for IAF would be to identify gaps in the overall AML system across all units in the bank, including the risk of bribery and corruption ³⁹⁰ within certain regions.

2.4.2.4 Banking Implications

The role of internal audit is thus compromised in many situations; for example, when problems are identified and/or there is a conflict in requirements between the audit committee and other banking units? In essence the IAF is placed in a position where they are answerable to internal bosses and a dual agency role between the audit committee and the priorities of governance. It makes the independent role of IAF very difficult to maintain- what if neither the audit committee nor the board listens to concerns that the IAF has about the risk exposure of the bank, does that place the IAF as the organisational whistle blower?

³⁸⁹ Donald R Cressey, "Other People's Money"(Montclair: Patterson Smith, 1973) p30
<http://www.acfe.com/fraud-triangle.aspx>

Another adaptation of this known as the Diamond Fraud model can be found in (Gbegi, 2013) which includes a fourth angle of capability, in addition to the other three sides of the triangle.

³⁹⁰ Ai, L. (2013). A cost-effective strategy of implementing international anti-corruption initiatives: Enhancing the role of anti-money laundering in combating corruption. *Journal of Money Laundering Control*, 16(1), 83-90. doi:10.1108/13685201311286887

One example of the complexities and dual roles of internal audit can be illustrated through one role that internal audit has been described as holding; which is to ensure that resources are prioritised adequately for the bank.³⁹¹ The difficulty with this role is that it will be heavily influenced by the body overseeing the work of IAF. So that if the audit committee has the primary oversight function then their assessment of IAF effectiveness will be linked to whether they view IAF audits as supporting their own funding and resource priorities for the bank. The management board may be the oversight body and their funding priorities for the strategic development of the bank may not always tally with the operational priorities of the audit committee. IAF effectively becomes the middle person to be bounced between the two and sometimes conflicting, pillars of governance. There is probably no easy solution to this dilemma since it is not possible to offer a truly independent function within a bank when that same function also has a vested interest in the outcome and is on the payroll of the organisation it is examining. Within the confines of this study the IAF could have the potential to act as an additional pair of eyes to ensure that the overall system is as effective as possible and avoid risk exposure from ML activity.

The dilemma of IAF and audit committee involvement has been defined by some researchers already³⁹² this is in addition to the existing challenges and potential conflict of trying to serve two different masters

³⁹¹ Castanheira, N., Lima Rodrigues, L., & Craig, R. (2009). Factors associated with the adoption of risk-based internal auditing. *Managerial Auditing Journal*, 25(1), 79-98. doi:10.1108/02686901011007315

³⁹² Lenz, R., & Sarens, G. (2012). Reflections on the internal auditing profession: What might have gone wrong? *Managerial Auditing Journal*, 27(6), 532-549. doi:10.1108/02686901211236382

between the audit committee and management.³⁹³ However, as banking becomes increasingly international in both its operational business and also in its compliance requirements, the question could be asked is there a more efficient use to which internal audit can be used? A clear role perhaps, one that removes it from being a pawn in the governance structure and instead gives it a central and clearly defined role, one that is more fitting for the expectations of today's banking structure.

2.5 Internal Audit and Financial Intelligence Analysis

One of the ways in which internal audit could become more independent is to retain its focus on its own audit findings. If these are not listened to, as suggested by some researchers³⁹⁴ then the IAF could report this to an outside body. At this stage Internal Audit is probably only one step away from being a whistle blower,³⁹⁵ given that the first part of the description by Yeoh (2014)³⁹⁶ is already part of the IA role.³⁹⁷ There could be other options though to enable IAF to report externally, in a more

³⁹³ Avianti, I. (2009). Relationship between internal audit function, audit committee and management reporting (A literature study in corporate governance implementation). Unpublished Working Paper. Department of Accounting, Padjaran University

³⁹⁴ Lenz, R., & Sarens, G. (2012). Reflections on the internal auditing profession: What might have gone wrong? *Managerial Auditing Journal*, 27(6), 532-549. doi:10.1108/02686901211236382

³⁹⁵ Call, A. C., Martin, G. S., Sharp, N. Y., & Wilde, J. H. (2014). The impact of whistleblowers on financial misrepresentation enforcement actions. Available at SSRN 2506418.

³⁹⁶ Yeoh, P. (2014). Enhancing effectiveness of anti-money laundering laws through whistleblowing. *J of Money Laundering Control*, 17(3), 327-342. doi:10.1108/jmlc-06-2013-0020

³⁹⁷ Coetzee, P., & Lubbe, D. (2013). Improving the efficiency and effectiveness of risk-based internal audit engagements. *International Journal of Auditing*, 18(2), 115-125. doi:10.1111/ijau.12016

structured way,³⁹⁸ since whistleblowing tends to be a last resort indicating that internal mechanisms have failed.

One example to consider could be to use the model of suspicious activity reports that are generated in money laundering cases, and are sent onto a national financial intelligence unit (FIU). This is done to provide dedicated resources and expertise to analyse the reports. If IAF had a similar system whereby an external audit committee was responsible for overseeing the work of IAF within different banks would this enhance the role of IAF within each bank? These regional audit committees could provide information on regulation, IT data software and feedback from FIUs, clarity on international terrorist activities and suspected country lists could be updated. As a model it would help to ensure a consistency to IAF roles within banks whilst at the same time ensuring that management would be receiving externally verified support but dedicated to their own internal systems. A regional unit would address some of the issues raised by Lenz & Sarens (2012) when they identified one of the weaknesses of IAF, as having to be answerable to multiple stakeholders. *“The more IA lacks a distinct chief stakeholder/“boss” and a clear and realistic role, the more it is principally exposed to over-promising and under-delivering.”*³⁹⁹

The reliance on audits, either internal or external, to uncover evidence of money laundering and trade based money laundering is

³⁹⁸ Alleyne, P., Hudaib, M., & Pike, R. (2013). Towards a conceptual model of whistle-blowing intentions among external auditors. *The British Accounting Review*, 45(1), 10-23

³⁹⁹ Lenz, R., & Sarens, G. (2012). Reflections on the internal auditing profession: What might have gone wrong? *Managerial Auditing Journal*, 27(6), 532-549. doi:10.1108/02686901211236382 p533

misplaced.⁴⁰⁰ Typically, when rogue clients use the banking process to launder money the paperwork is pristine, and in order. It is impossible for an auditor to investigate the underlying reality of every transaction, particularly when the paperwork itself is not in the least suspicious.⁴⁰¹

In fact, the only reason banks cannot spot money laundering themselves⁴⁰² (i.e. prior to criminal investigation) is that all required documents are in perfect order. Banks, being large and complex entities, consist of numerous departments with overlapping functions that manage a myriad of products.⁴⁰³ Risk assessment is standardised, especially within the retail-banking sector, by applying rigor to the validation of client documentation;⁴⁰⁴ however, once the documentation is deemed correct and in order, the system pays out.⁴⁰⁵

Money laundering and trade based money laundering schemes are initiated with the twin purposes of laundering illicit funds, and remaining undetected; by nature, they are indistinguishable from legal transactions, even during the application of sound and thorough audit methodologies

⁴⁰⁰ ICAEW, (2010) AUDIT OF BANKS: LESSONS FROM THE CRISIS Inspiring Confidence in Financial Services initiative. Retreivable from: <https://www.icaew.com/-/media/corporate/archive/files/technical/financial-services/audit-of-banks-lessons-from-the-crisis.ashx?la=en>

⁴⁰¹ Reuter, P., & Truman, E. M. (2004). Chasing dirty money: The fight against money laundering. Washington, DC: Institute for International Economics

⁴⁰² PWC. (2013) The Client Assets Policy & Risk Team Client Assets Unit - Retrieved from <https://www.pwc.co.uk/assets/pdf/pwc-response-cp-13-5-11-october-2013.pdf>

⁴⁰³ Luyendijk, Joris. (2012) External auditor: 'Nobody at a bank can have a complete overview any more' Retrieved From <https://www.theguardian.com/commentisfree/joris-luyendijk-banking-blog/2012/apr/28/banks-accounts-external-auditor>

⁴⁰⁴ McKinsey (2014) Creating a Robust Risk-and-Control Framework in Mortgage Lending and Servicing retrieved from <http://www.mckinsey.com/~media/McKinsey/Industries/Financial%20Services/Our%20Insights/Creating%20a%20robust%20risk%20and%20control%20framework/Creating%20a%20robust%20risk%20and%20control%20framework%20in%20mortgage%20lending%20and%20servicing.ashx>

⁴⁰⁵ ECB (2009) Glossary of terms related to payment clearing and settlement systems. Available at :<https://www.ecb.europa.eu/pub/pdf/other/glossaryrelatedtopaymentclearingandsettlementsystemsen.pdf>

and practices. Additionally, the blame ⁴⁰⁶ is not attributable to the audit function, which must be viewed as having a limited scope and ability. It is a common misrepresentation of both audit functions ⁴⁰⁷ that they are able, and should, uncover forensic details of financial crimes. The sheer workload and process of an audit relies on, and assumes absolutely, that banks only act on paperwork that is perfectly in order. If suspicion is not aroused by either banking staff or evidence of dubious transactions, then in no way ⁴⁰⁸ will any auditor (internal or external) be able to identify the transaction as a risk.

This fact was substantially illustrated in the Kingston Cotton Mills case ⁴⁰⁹ of 1896, where Lord Justice Lopes found that, *“An auditor is not bound to be a detective or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care.”*

⁴⁰⁶ Eaglesham, J. (2001) 'Auditor's Failure to Detect Leeson Fraud Blamed for Bank's Downfall', Financial Times, 25 October

⁴⁰⁷ Ojo, M. (2006) The Role of External Auditors and International Accounting Bodies in Financial Regulation and Supervision. ICAEW University Press.

ICAEW, (2010) Audit of Banks: Lessons from the Crisis Inspiring Confidence in Financial Services initiative. Retrieved from : <https://www.icaew.com/-/media/corporate/archive/files/technical/financial-services/audit-of-banks-lessons-from-the-crisis.ashx?la=en>

⁴⁰⁸ Reuter, P., & Truman, E. M. (2004). Chasing dirty money: The fight against money laundering. Washington, DC: Institute for International Economics

⁴⁰⁹ Morgan, Janet (2000) Auditors: 'Watchdog OR Bloodhound'? Retrieved from http://www.rohanchambers.com/Courses/Auditing/auditors_watchdog_or_bloodhound.htm

More recently, the limitations of both internal and external audit functions in relation to financial institutions' operations and structure ⁴¹⁰ were clearly illustrated in the spectacular failure of Barings, ⁴¹¹ BCCI, Worldcom, Enron, Parmalat, HBOS, RBS and Northern Rock. ⁴¹² It is outside the scope of this research to suggest a detailed role for the IAF, However, the role is discussed further in relation to AML compliance, and in particular to the changing nature of international money laundering and the need for increased inter-bank co-operation.

2.5.1 AML Compliance

A normal AML compliance system consists of a number of processes and checks that ensure that client's details are verified and that the business being operated is actually owned by the client. Other checks are also carried out such as to ascertain that the transactions recorded are for the activities stated by the client. Within banking one of the key mechanisms for ensuring these checks are carried out is the customer due diligence process (CDD) and beneficial ownership information (BOI) checks.⁴¹³ If either the business or the client is seen to be complicated in any way or is deemed potentially suspicious then a suspicious alert is raised internally and another system of enhanced due diligence checks can be undertaken by the bank. If during the further process of undertaking

⁴¹⁰Greener, Ian. (2006) 'Nick Leeson and the Collapse of Barings Bank: Socio-Technical Networks and the 'Rogue Trader' Organization, vol. 13, 3: pp. 421-441. , First Published May 1, 2006."

⁴¹¹Stonham, Paul. (1996) Whatever happened at Barings? Part one: The lure of derivatives and collapse, European Management Journal, 1996, pp. 167-175.

⁴¹² Hamilton, S. and Micklethwait, A., 2016. Greed and corporate failure: The lessons from recent disasters. Springer.

⁴¹³Webb, L. (2004). A survey of money laundering reporting officers and their attitudes towards money laundering regulations. Journal of Money Laundering Control, 7(4), 367-375

these enhanced levels of checks anything suspicious is flagged up by the bank, then a suspicious activity report (or SAR) is filed, this is external to the bank and sent on to the financial investigation unit for them to undertake further analysis.

2.5.2 Internal Audit and Risk Assessment

Mihret (2014) suggested that the assurance aspect of IAF could be developed further in order to support AML compliance within the bank “[IAF]...helps prevent and detect irregularities that could result from mistakes or fraud.”⁴¹⁴ If that was the case, then there is a clearer argument for IAF to oversee the AML compliance unit. The difficulty is that in order for IAF to achieve this effectively, they would have to be part of the risk assessment design and monitoring process, and understand all the complexities of AML. Does this lead to a danger of merely duplicating the work of AML? Similarly, PwC (2014) recently stated that improved data was one of the main issues in the TBML detection race, and there could be a role for internal audit to become *au fait* with the latest IT and software programmes for AML.

However, all these suggestions merely seem to be subsuming IAF into existing areas of work, already being done by existing units within the bank. The agency dilemma still exists with the pull between strategic

⁴¹⁴ Mihret, D. G. (2014). How can we explain internal auditing? The inadequacy of agency theory and a labour process alternative. *Critical Perspectives on Accounting*, 25(8), 771-782. doi:10.1016/j.cpa.2014.01.00 p777

oversight and operational assurance and IAF is no clearer on its specialism and unique qualities that it brings to governance and AML compliance.

2.6 Conclusion

The chapter has covered an array of different issues in an attempt to cover the basic tenets of TBML activity as it specifically affects the global banking sector. The key points that have been covered in this review have focused on how trade-based money laundering is a growing area of concern for both banks and regulators as it becomes the method of choice for many criminal gangs to move goods and money across the globe.⁴¹⁵ The empirical research would suggest that banks have a limited understanding of the types of activities that TBML could present to the bank and/or how to adequately assess the bank's risk of exposure to TBML.⁴¹⁶ In this respect there would appear to be a clear need for changes within the governance and audit structures of the bank and in particular for internal audit to play an enhanced role in AML regulation, compliance and suspicious reporting.⁴¹⁷

In order to explore this issue further the research will explore the perception of those working in the sector and what their responses towards the current risk assessment processes for TBML are. Alongside this information the research will also explore other relevant models that could protect the bank and its stakeholders from the impact of TBML. The gap in the literature that has emerged and which this research seeks to contribute towards addressing, is to consider an appropriate risk assessment

⁴¹⁵ AUSTRAC. (2013). Typologies and case studies report 2013. Australia: AUSTRAC Retrieved from http://www.austrac.gov.au/sites/default/files/documents/typ13_full.pdf

⁴¹⁶ PwC. (2014). Goods gone bad. Addressing money-laundering risk in the trade finance system.

⁴¹⁷ FCA. (2013). Bank's control of financial crime risks in trade finance. London: Financial Conduct Authority.

approach that could be easily implemented within the banking system. In particular, there appears to be a need to analyse the red flag indicators of client behaviour and transaction patterns that accompany TBML activities, and from this information to develop an empirical model with its underpinning theoretical assumptions, which can accurately detect TBML risk within a global banking context.

In developing such a risk assessment tool this research uses an ontological perspective that risk assessment approaches for TBML transactions involve dealing with complex social and financial processes in trade based money laundering. There is often the involvement of multiple financiers and businesses ⁴¹⁸ and the business transactions can be located across a range of different countries. This means that in effect each bank will only ever be presented with a small component of a much larger financial operation. Therefore, in order for TBML activity to be effectively assessed there need to be links either between different banks and/or between law enforcement, financial intelligence units and banks.⁴¹⁹

This paper has focused on one small but important area, the overlap between trade-based money laundering and the banking sector. Unlike previous research that has provided a focus on TBML, which has tended to cover aspects of how it operates and the economic predictions on its impact, there is also scope for research to support financial institutions in their fight against TBML. This research aims to focus specifically on the

⁴¹⁸ APG. (2012). APG Typology Report on Trade Based Money Laundering. Sydney: Asia Pacific Group on Money Laundering.

⁴¹⁹ AUSTRAC. (2013). Typologies and case studies report 2013. Australia: AUSTRAC Retrieved from http://www.austrac.gov.au/sites/default/files/documents/typ13_full.pdf

banking context and to be realistic about the limited financial information that banks are likely to have at any one time, for each TBML client. The research is considering a model that focuses on the strengths of the banking sector which is to assess business risk. The risk assessment model to be developed should still form the basis of the bank's own business work and AML compliance tasks should fit into this model of working rather than the other way around.

2.6.1 Empirical Implications

From the above analysis and in order to process information effectively and efficiently, it would appear that a combination of approaches could be the logical solution towards addressing TBML risks in banking.⁴²⁰ Since many banking units are involved in TBML including front office, business, trade and internal audit then a cohesive system that can be tiered across all these units to suit the different knowledge bases would be ideal. This could include a broad rule based framework which was then supported by a risk based strategy.⁴²¹ This could then enable information to be processed quicker and with more meaning. This could lead to an approach similar to that of the Netherlands,⁴²² which contrary to other countries has seen a reduction in SAR reports but with an increased quality

⁴²⁰Camacho, A. R. (2013). Modelling the risk profiles of clients in the fight against money laundering and terrorism financing. *International Journal of Business and Economics*, 12(2), 97-120

⁴²¹Hoffmann, L. (2012). Critical look at the current international response to combat trade-based money laundering: The risk-based customs audit as a solution, *A. Tex. Int'l LJ*, 48, 325.

⁴²²Soudijn, M. R. J. (2014). A critical approach to trade-based money laundering. *J of Money Laundering Control*, 17(2), 230-242. doi:10.1108/jmlc-01-2013-0001

of material being reported.⁴²³ Otherwise the situation continues to prevail as in most other countries, where there has been increased reporting of SARs but this has led to a diminishing amount of quality information produced ⁴²⁴ resulting in less information or evidence to work from, described by economists in the theory of 'Crying Wolf'.⁴²⁵

From the literature it would appear that in order to process information banks need guidance beyond a list of red flags, which is growing exponentially as each new money laundering scheme is uncovered. In other words, the red flags need to be part of an overall risk assessment system that enables staff to process what information they have gathered and link it directly into their own system of reviewing client accounts and transactions. Computer systems may be able to speed up reviewing transaction patterns but if the operator is not aware of what information to request then this could be a wasted resource. The rest of the literature review considered the different elements that would need to be considered when developing even a simple risk assessment design and to identify which red flag information would need to be incorporated into a risk based framework.

The literature also highlighted several reports warning against increased regulation and its impact aside from the resource implications to the banking sector and the additional burden this would place on AML

⁴²³ Unger, B., & van Waarden, F. (2009). How to dodge drowning in data? Rule- and risk-based anti money laundering policies compared. *Review of Law & Economics*, 5(2). doi:10.2202/1555-5879.142

⁴²⁴ Estreich, J. (2013). How to build an audit risk assessment tool to combat money laundering and terrorist financing. [White Paper] (White Paper). ACAMS

⁴²⁵ Takáts, E. (2007). A theory of "crying wolf": The economics of money laundering enforcement. Ana Lucia Corofnel. IMF Working Paper

compliance units in banks. In particular McCarthy, van Santen, & Fiedler, (2014) highlighted the possible negative impact that regulation alone would have on curtailing money laundering activity,⁴²⁶ and the risks it could cause to developing professional money launderers using trained former finance staff.⁴²⁷ McCarthy et al suggested in their study that investment into police services to track and capture money launderers would ultimately be a more productive and effective use of resources, rather than increasing the cost of regulation and compliance monitoring. This would strengthen investigation work from the law enforcement side but it could still increase the time and effort the banks spend on AML compliance, except they now support law enforcement efforts rather than regulator inquiries. In addition, McCarthy determined that a focus on banking regulation would produce little or no impact in stemming the involvement of professional money launders thus making it increasingly more difficult to trace money as it is being hidden by professional finance people.

“Current approaches, we find, do not deter money launderers from supplying the market, but simply increase the profitability of money laundering.”⁴²⁸

⁴²⁶ McCarthy, K. J., van Santen, P., & Fiedler, I. (2014). Modelling the money launderer: Micro theoretical arguments on anti-money laundering policy. *International Review of Law and Economics*. doi:10.1016/j.irl.2014.04.006

⁴²⁷ Hansen, L. L. (2009). Corporate financial crime: Social diagnosis and treatment. *Journal of Financial Crime*, 16(1), 28-40. doi:10.1108/13590790910924948

⁴²⁸ McCarthy, K. J., van Santen, P., & Fiedler, I. (2014). Modelling the money launderer: Micro theoretical arguments on anti-money laundering policy. *International Review of Law and Economics*. doi:10.1016/j.irl.2014.04.006 p8

2.6.2 Key Findings

At this stage in the research a number of topics and possible solutions have begun to emerge from the literature review. The practical data collection stage will seek to examine some of these preliminary suggestions or concepts in more detail and explore the empirical implications for staff working in the field. The final part of the literature section provides a summary of some of the key points that could be examined for further exploration.

2.6.3 Risk Based system

A risk based approach to AML compliance should enable banks to use their own flexibility and incorporate simple business viability models, to determine the likelihood of whether their client's business proposal is legitimate or not. This would move the focus of banks away from determining the source of the money and instead focus on the business model being presented to them. There will still be questions asked in relation to whether there is a risk of illegal money being used or whether by funding this transaction illegal activity will occur. If during the course of their analysis flags are raised, then outside sources of expertise can be brought in.

2.6.4 Banking Definition and Focus for TBML detection

In law enforcement there has to be a clear pattern of criminal activity in order for a successful conviction to occur, so perhaps banking and legal definitions of TBML need to overlap at some point. In order for a fraudulent transaction to be successful in a bank, which implements robust AML compliance measures, then an element of deception and fraud is required by the client. It is this level of deception and fraud that is the responsibility of the bank to uncover, since it is undermining their own risk analysis of the business being undertaken not to do so. From the case study examples it can also be seen that the banking definition of trade-based money laundering has to be tied into a ML risk assessment of a client's overall business proposal. The additional component from an ordinary assessment is the source of the materials being used (cash /goods or services). The bank cannot determine whether these are from illegal gains but it can highlight whether it is possible to run this proposal using cash or goods acquired illegally. Perhaps a more accurate definition of TBML for the banking sector would be "The use of the financial services to facilitate the movement of money, through the use of fraud or deception". This clearly defines the role that banks have in engaging with TBML activities because their own systems of risk assessment will have been compromised by the deception process.

2.6.5 Implication for the Governance of Banks

The globalisation of financial crime and money laundering⁴²⁹ has implications for the management and governance of financial institutions throughout the world. The expansion of international money laundering activity and the constant evolvement of techniques such as trade based money laundering means that other banking units apart from AML compliance, such as trade finance and internal audit, need to become centre staged. In addition, individual banks also need to be working together to commission and develop the specific software systems that they need, in order to track and detect money laundering and spot anomalies in their client's business transactions. This requires adaptations in AML specialisation across all the banking units and feedback into software developing platforms.⁴³⁰

This chapter has explored the contextual framework to the research and outlined the main theoretical and empirical challenges associated with money laundering activity and its detection within the formal banking sector. The next chapters are of the research focus on an empirical survey and follow up interviews undertaken with leading AML experts across the globe. The survey asked what are the current challenges that AML staff face, and where so they feel future priorities should lie.

⁴²⁹ Amone, M., & Borlini, L. (2010). International anti-money laundering programs. *J of Money Laundering Control*, 13(3), 226-271. doi:10.1108/1368520101105713

⁴³⁰ Ai, L., & Tang, J. (2011). Risk-based approach for designing enterprise-wide AML information system solution. *Journal of Financial Crime*, 18(3), 268-276.

The reason for undertaking this survey was to enable the researcher to examine the results of existing industry reports ⁴³¹ and to see if any other developments had occurred within the sector, specifically within AML compliance. The survey was also designed to explore what role internal audit ⁴³² played in AML risk assessment and governance reporting, which would not be a standard question within most industry AML surveys. Finally, it was hoped that the survey and follow on interview questions would give additional insights into what the current problems and challenges in the AML sector were. These were expected to focus on the type of input required from governance and management, training needs and staff to be trained, use of risk assessment strategies and future resource implications.

⁴³¹ PwC. (2014). Goods gone bad. Addressing money-laundering risk in the trade finance system. KPMG. (2014). Global anti-money laundering survey. Retrieved from <https://www.kpmg.com/KY/en/IssuesAndInsights/ArticlesPublications/PublishingImages/global-anti-money-laundering-survey-v3.pdf>

GT Canada AML Survey Result. (2015). GT Canada AML survey result. (National Anti-Money Laundering survey report 2015).

⁴³² PwC. (2014). Internal audit holding the line on BSA/AML compliance. Retrieved from <http://antimoneylaundering-fiba.com/files/1499.pdf>

CHAPTER 3 ACADEMIC BACKGROUND

3.1 Introduction

This section focuses on the academic and empirical literature that was used in the research and which helped to provide a background context for the work being studied. Every piece of research needs to fit into other studies undertaken in the same area so that research students and other experts can develop a bigger picture of what is happening. This section reviewed and studied the literature that was seen as relevant to this study area, i.e. trade based money laundering in the banking sector.

Most literature reviews are written to provide evidence for a research project or support a particular viewpoint in which to justify the direction of the research.⁴³³ This review is no exception, since its focus is on trying to present a contextual framework that explains and justifies the research approach and methodology. The overall approach of the research was to be an exploratory piece, since the subject matter is still an emerging issue and there are relatively few papers on the subject matter. Perhaps most notably there were very few academic papers⁴³⁴ that had conducted primary research on the topic, so there were challenges when choosing a comparable technique or using established baseline data. Instead the

⁴³³ Hamilton, H., & Clare, J. (2004). Reviewing the literature: Making 'the literature' work for you. *Collegian*, 11(1), 8-11.

⁴³⁴ Naheem, M.A., 2015. Trade based money laundering: towards a working definition for the banking sector. *Journal of Money Laundering Control*, 18(4), pp.513-524.

Naheem, M.A., 2016. Trade Based Money laundering: A primer for banking staff. *International Journal of Disclosure and Governance*, 13: 135. doi:10.1057/jdg.2015.10.

Ferwerda, J., Kattenberg, M., Chang, H.H., Unger, B., Groot, L. and Bikker, J.A., 2013. Gravity models of trade-based money laundering. *Applied Economics*, 45(22), pp.3170-3182.

RJ Soudijn, M., 2014. A critical approach to trade-based money laundering. *Journal of Money Laundering Control*, 17(2), pp.230-242.

Liao, J. and Acharya, A., 2011. Transshipment and trade-based money laundering. *Journal of Money Laundering Control*, 14(1), pp.79-92.

review collated opinions from within the sector, which could then be used to support or enhance the discussions from the research's own primary data. In addition to the peer reviewed articles the search was expanded to include a certain element of 'grey literature' which includes items such as policy documents and reviews.⁴³⁵ These were included in the review section in order to ensure that any publisher bias that might occur from only using the limited number of printed articles on the subject matter, did not lead to any distortions in developing an accurate context.

3.1.1 Systematic Review

The type of literature review that has been adopted for this paper is a systematic review, as opposed to the older more traditional narrative literature review.⁴³⁶ The main difference between the two techniques is that a systematic review is a piece of mini research that explores and collects a number of different articles in order to answer a specific literature question.⁴³⁷ A traditional review usually focuses on specific keywords and collects all papers using this phrase. In the case of this research the literature question focused on what information does the paper provide on TBML (see the following page for the sample coding techniques applied).

⁴³⁵ Hamilton, H., & Clare, J. (2004). Reviewing the literature: Making 'the literature' work for you. *Collegian*, 11(1), 8-11.

⁴³⁶ Rhoades, E. A. (2011). Literature Reviews. *The Volta Review*, 111(1), 61+. Retrieved from <http://www.questia.com>

⁴³⁷ Nasser-Moghadam, S., & Malekzadeh, R. (2006). Systematic review: Is it different from the traditional review. *Arch Iran Med*, 9(3), 196-9

Table 2: Sample coding paper

Colour	Code	Paper	Summary
Yellow	Generic ML information	Focus on IAF and role with Audit committee	Pull between different agendas of management and audit committee
Blue	TBML		
Green	Authors comments		
Pink	Methodology either their research or implications for this project	Interviewed 134 Chief Internal Auditors across various companies - On resources in 2005 Used 3 factors - budgetary control, termination rights & reporting lines	10% from financial services Used Agency-model economic application of agency costs associated with monitoring
Purple	Findings	Less than 5% of IA time spent on risk management, compliance and fraud audits combined.	Correlation suggested between level of involvement and oversight by audit committee and focus on internal control functions rather than other areas
Orange	Other	Breakdown of IAF activities	

The systemic approach enabled the criteria used by Hamilton and Clare of relevance, credibility and authenticity to be incorporated more easily, because the analysis looked at whether practical research, opinion or analysis of other papers was used. This was important because the topic had been written on by a number of different disciplines across law, economics, accounting and banking regulation and the thesis wanted to ensure some consistency in comparing and using papers from across multiple disciplines.

The particular question the review was seeking to answer was to determine what the key themes and topics were related to the issue of trade based money laundering. Most of the research reports were qualitative or discussion papers and as noted by Evans and Pearson ⁴³⁸ there are differences in reviewing qualitative research compared to the random control designs of quantitative research. In qualitative research it is more exploratory and interpretative in nature, and each situation is different. In this research there was also a global review of literature, which added other differences into the interpretation, such as cultural differences, exposure to different types of criminal organisational activity and the different stages of progress in national legislative and banking regulation.

Most papers on ML activity were fairly generic ⁴³⁹ and included discussion on either legal frameworks,⁴⁴⁰ definitions, typologies or cases ⁴⁴¹

⁴³⁸ Evans, D., & Pearson, A. (2001). Systematic reviews of qualitative research. *Clinical Effectiveness in Nursing*, 5(3), 111-119. doi:10.1054/cein.2001.021

⁴³⁹ Amone, M., & Borlini, L. (2010). International anti-money laundering programs. *J of Money Laundering Control*, 13(3), 226-271. doi:10.1108/13685201011057136

⁴⁴⁰ Durrieu, R. (2013). *Rethinking money laundering & financing of terrorism in international law*. Boston: Martinus Nijhoff.

and challenges facing banks / other financial services or agencies.⁴⁴² Some published papers contributed a little piece to each theme⁴⁴³ and so at the same time covered all the themes. This is probably a typical challenge with new and emerging topics but it became a very piecemeal approach. Although there are exceptions to this with some authors very specialised on certain topics, there are many authors who keep appearing in many of the sections of the review because of the more generic nature of their work.

3.2 Literature Methodology

The literature review has used a systemic approach to reviewing and analysing content relevant to TBML activity within the global banking sector. This meant that academic research specific to this topic was analysed using specific headings and from within a specific time period as outlined in the following section. Given the limited availability of specific cases and the relative newness of TBML being recognised as a specific type of money laundering activity,⁴⁴⁴ the research has used findings from academic journal articles alongside empirical papers and typology reports.

⁴⁴¹ AUSTRAC. (2011). Typologies and case studies report. Australia.

⁴⁴² Lui, A. (2013). Macro and micro prudential regulatory failures between banks in the United Kingdom and Australia 2004-2009. *Journal of Financial Regulation and Compliance*, 21(3), 241-258.

⁴⁴³ McDowell, J., & Novis, G. (2001). The consequences of money laundering and financial crime. *Economic Perspectives*, An Electronic Journal of the U.S. Department of State, 6(2).

⁴⁴⁴ FATF. (2006). Trade based money laundering. France. Financial Action Task Force

3.2.1 Scope of the review

The purpose of the literature review was to establish the full context of TBML activity and the issues that the sector was trying to address. Since the recognition of TBML activity is fairly recent within the financial and trade sectors, the literature review concentrated on a period covering the last 12 years i.e. from 2004 until present. The review used academic journals across a number of areas including, auditing, financial crime, criminology, money laundering, economics and law. In addition, specific TBML reports have been used, especially those developed through the various regulatory bodies including the FATF, The World Bank and Financial Intelligence Unit publications across different jurisdictions.

The literature has been themed using a funnel approach starting from the general financial crime topic and narrowing the focus down to consider money laundering schemes and finally, the specifics of TBML transactions. In other words, all papers that were written on financial crime were originally considered; however, the literature question was only interested in links to TBML. The difficulty was that many disciplines have only recently started separating TBML from other money laundering activity so earlier papers in particular may have mentioned TBML activity but not used the name explicitly.

In response to the emerging topics that were raised in the preliminary literature review, the final review also considered the regulatory and response frameworks for addressing TBML activity. The aim of the

data collection section of the research was to consider how the role of banks could be used to ensure that an appropriate risk assessment strategy was developed. The literature review aimed to develop a clearer context to illustrate how that engagement would be most meaningful.

3.2.2 Literature Search

The literature headings were initially developed during the course of the proposal writing and the preliminary literature review process. It was decided that the review would focus on four key areas of

- Financial crime,
- Money laundering (TBML),
- Bank responses and
- Risk assessment / compliance.

These four areas were divided across the two main emerging literature themes, which were; 'Crime' and 'Regulatory Response'.

3.2.3 Crime

This looked at the area of financial crime and some of the specific typologies of crime and techniques used in money laundering activities. It also focused on the criminal behaviour, theories of white collar crime and reasons for money laundering. This section was subdivided into two main areas: Criminal Motivation and Money Laundering / TBML regulation.

3.2.3.1 Criminal Motivation

Initially the research was open to considering the broader realm of general financial crime and the theories of criminal behaviour and motivation. As the literature review developed it became clearer that the only link to financial crime activity and theories that this research actually needed was relation to the AML risk assessment faults, which were identified in the legal cases. These were used as secondary data on money laundering activity, but which could equally be applied to TBML.

3.2.3.2 Money Laundering / TBML regulation

This explored the specific typologies of TBML and the kinds of situations that could be presented to the banks. It looked at case studies from across a number of countries, since most typology studies tended to be specific to only one country or region.

3.2.4 Banking Regulatory Response

The second section of the literature review focused on the regulation, legal context and risk assessment techniques currently employed by banks to combat TBML and money laundering generally.

3.2.4.1 Intelligence Data

Many of the global reports and surveys that are widely available such as the KPMG report or PWC publications⁴⁴⁵ were very broad and generic and often non-specific in relation to TBML, instead they focused on financial crime generally including fraud, money laundering and tax evasion. In order to source specific TBML examples and to critically analyse the findings, the literature review considered articles that were more specific to one region or country such as the AUSTRAC reports, these provided typologies and sanitized case studies that had been developed from actual events.

3.2.5 Risk Assessment & AML Compliance

Many of the papers that were in this section were descriptive papers that explained the various compliance requirements of individual countries. These papers did provide insights into the progress that countries were making on applying the FATF guidelines on suspicious alerts and monitoring suspicious client accounts.

The research was also interested in the governance and internal audit responses to AML compliance. There were limited papers available on this topic since most AML regulation focused papers dealt with the issues affecting the direct staff involved in AML compliance, which are the

⁴⁴⁵ KPMG. (2014). Global anti-money laundering survey

Money Laundering reporting officers (MLROs). This fact in itself said a lot in relation to the role of internal audit and AML, and so the lack of data in certain areas also became of interest during the review.

The four headings listed above were also sub divided into the three types of literature sources as shown below, in table 3.

Table 3: Sub-division of different literature sources (*The literature has been sub categorised into four key areas. The broader background area of financial crime linking into money laundering specifically and then the focus of this research, which is trade based money laundering.*)

	Financial Crime	Regulatory Response		
Primary theme	Financial Crime	Money Laundering	Bank	AML Risk Assessment Approaches
Practical Literature	Survey based responses on types of crime across banking sector	Trade Based Money Laundering, case study examples (FATF, World Bank)	Red Flag issues	Know Your Customer, Customer Due Diligence, Corporate governance, Compliance & Regulation (AML focus) AML legal frameworks
Theoretical 'Risk Based' framework	White Collar Crime. Criminal motivation theories.	Criminal motivation and Economic Criminology theories.	Agency theory / Game theory responses by bank and client	Agency relationships. Theories on impact of regulatory approach (AML focus).
Research Literature	Impact of crime on banks	Case study analysis and documentation	Regulatory roles and Legislation	Impact of regulation on banking efficiency

The four headings above were also subdivided into three types of literature sources as shown in the table above. These were empirical studies and reports from the banking and regulatory sectors; theoretical and academic literature on any of the themes and finally, generic research literature that might provide more general links to the topics, this might include investigative journalism and political media reports on certain countries where money laundering or TBML activity had been the subject of discussion.

3.3 CRIMINAL MOTIVATION

3.3.1 Client Behaviour - Money Launderer Behaviour

The other side of Game theory is to try and predict how criminal behaviour and ML crimes will change as regulation changes.⁴⁴⁶ One of the ways in which the Game theory has been applied is to analyse the relationship and the bargaining game that occurs between criminals who acquire dirty money and the professional launderers who have access and knowledge of the financial services sector. Traditionally these roles have been seen as one and the same, but increasingly it is recognised that experts and financial professionals can also be involved at this stage of the ML placing and layering processes. According to McCarthy, van

⁴⁴⁶ Soudijn, M. (2014). A Critical Approach to Trade-Based Money Laundering. *Journal of Money Laundering Control* Vol 17, Iss 2, 230-242.

Santen, & Fiedler, (2014) the behaviour of professional money launderers is a vital component in the overall regulatory equation. Many financial professionals are in well paid jobs and ML is a risk to them and their reputation.⁴⁴⁷ However, as criminals need to acquire greater financial skills in order to combat the increasing complex regulation requirements, then the cost that these professionals can charge for their services will also increase. A point will inevitably be reached whereby it pays more for the professional to launder money than to focus on the paid job and the reputation. Another side effect therefore of increased regulation is that a market of skilled professional launderers will be developed and strengthened.⁴⁴⁸

In part the reason that TBML has become such an emerging area of concern for the financial and trade sectors, is because criminal syndicates have responded to the increase in AML regulation, designed for other traditional sources of ML such as cash smuggling and the use of financial institutions.⁴⁴⁹ TBML has thus become the next stage in defeating regulation, and the type of response developed from within the financial and trade sectors, to combat this problem, will determine to a large extent the future direction of ML activity. Game theory has been used to highlight the complexity and see-saw elements of regulation and to predict or highlight the likely effects of change in this area. The learnings from Game

⁴⁴⁷ Hansen, L. (2013). "Gossip boys": Insider trading and regulatory ambiguity. *Journal of Financial Crime*, 21(1), 29-43. doi:10.1108/jfc-04-2013-0030

⁴⁴⁸ McCarthy, K. J., van Santen, P., & Fiedler, I. (2014). Modelling the money launderer: Micro theoretical arguments on anti-money laundering policy. *International Review of Law and Economics*. doi:10.1016/j.irle.2014.04.00

⁴⁴⁹ FATF Guidance. (2013). *National Money Laundering and Terrorist Financing Risk Assessment*. Paris: Financial Action Task Force.

theory have also been applied to the relationship between the bank and the client and both elements have been included in the theoretical framework of this project. It is however beyond the scope of this project to undertake a full Game theory analysis, for any of the options suggested above as part of the data analysis.

In all of these theoretical contexts and banking scenarios, the role of the bank is recognised as a middle player between the demands of the state agencies and AML regulation on one side, and the demands of the clients who are laundering money on the other side. It is only by understanding the two game theory scenarios and their link to agency relationships that the full complexity of AML compliance can be realised.

3.3.2 Criminal Motivation Theories

The theoretical framework for the research includes three different but interrelated aspects, which are;

1. The regulatory response
2. The banking processes
3. The client's responses

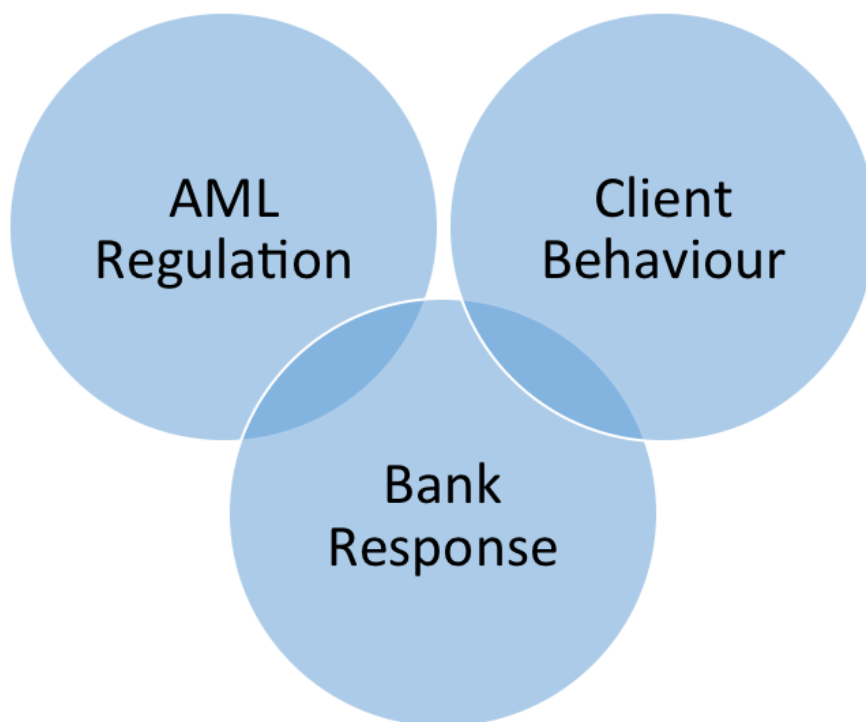


Figure 2: AML risk model

AML risk model for bank responses is based on two major factors, the behaviour of the client and the requirements of the AML regulation. It is the Principal – Agent- Client relationship which governs AML risk assessment in banks.⁴⁵⁰

For each one of these empirical elements the research is making the assumption that an Agency relationship exists between the various players. However, in order to fully understand the relationships involving the risk taking behaviour of TBML clients, more information is required about the crime and the criminal. From this information it should be possible to develop a more in-depth understanding of the criminal decision-making process. This knowledge can then be incorporated into

⁴⁵⁰ Pellegrina & Masciandaro, 2008

the theoretic framework, in order to determine the importance of the various influences on criminal decision making. These influences will include understanding criminal motivation options and being able to assess the risk for potential corruption or insider involvement.⁴⁵¹ This is also linked to knowing the capacity of criminals to access resources, including support networks and to have an understanding of the criminal networking structures.⁴⁵² Finally, it will provide knowledge of the economic factors that will influence the market for and availability of, professional money launderers.⁴⁵³

All these different elements are necessary to understand, in order to ascertain how TBML operations can succeed and the actual risk that they pose to banks. By developing a deeper understanding of criminal thinking it is possible to understand how criminals can influence or corrupt individual bank employees to facilitate their ML activities. In essence banks and regulatory bodies need to be able to think as an ML operative would think, in order to know the questions that risk assessment processes should be asking.⁴⁵⁴ The application of this multi-discipline framework for the topic of TBML activity across the banking sector, is an original approach that this research offers.

⁴⁵¹ Hansen, L. L. (2009). Corporate financial crime: Social diagnosis and treatment. *Journal of Financial Crime*, 16(1), 28-40. doi:10.1108/13590790910924948

⁴⁵² Burt, R. S. (2001) Structural holes versus network closure as social capital. In: Lin, N., Cook, K. and Burt, R. S. (eds.) *Social Capital: Theory and Research* (pp. 31-56). New York: Aldine de Gruyter.

⁴⁵³ McCarthy, K. J., van Santen, P., & Fiedler, I. (2014). Modelling the money launderer: Micro theoretical arguments on anti-money laundering policy. *International Review of Law and Economics*. doi:10.1016/j.irl.2014.04.00

⁴⁵⁴ Swecker, C. (2015) *Financial Criminal Enterprises Innovate* http://info.verafin.com/rs/verafin/images/Verafin_White_Paper_Swecker_Financial_Criminal_Enterprises_Innovate.pdf accessed 20 August 2015

3.3.3 Criminals

Crime is inevitable to some extent but the motivation of individuals to become involved in financial criminal activity can vary.⁴⁵⁵ One of the main economic motivations for ordinary people to enter into criminal activity is when the cost of being involved in crime is more profitable than working within the legitimate sector. McCarthy, van Santen & Fielder described this phenomenon in their Agency theory model for understanding how professional money launderers were recruited.⁴⁵⁶ As a result of this information one of the challenges for any work undertaken in developing risk assessment for ML, is to ensure that one of the consequences of the risk assessment approach is not to increase the profitability of supporting money launderers, since this would be counterproductive if the aim is to reduce the amount of ML activity within the banking structure.

Another challenge is to try and encourage money launderers to maintain some link with the formal banking sector, in order for regulation and law enforcement agencies to catch them, otherwise there is a risk of driving the activity into the shadow banking sector which has minimal regulation and control.

⁴⁵⁵ Gottschalk, P. (2013). White-Collar criminals in modern management

⁴⁵⁶ McCarthy, K. J., van Santen, P., & Fiedler, I. (2014). Modelling the money launderer: Micro theoretical arguments on anti-money laundering policy. *International Review of Law and Economics*. doi:10.1016/j.irle.2014.04.00

The ability to change direction in response to challenges and opportunities has already been described through agency theory. Some of the supporters and even critics of agency theory have specifically focused on the concept of opportunism amongst agents,⁴⁵⁷ which is also a key component in determining the potential for some white collar crime.⁴⁵⁸ Although Wright, Mukherji & Kroll, (2001) challenge the traditional concept in agency theory, declaring that agents do not have any financial benefit in supporting the principal, they still neglected to focus on the financial benefits when rogue agents decide to support criminal activity and do receive financial reward; albeit at the risk of losing their own salary and job should they be caught. This is noted by their statement on risk aversion and diversification when they state that “*agents cannot diversify their employment,*”⁴⁵⁹ whereas agents acting as bank officials and also facilitating money laundering are actually illustrating diversification. It would appear from an analysis of these pieces of research that the preponderance towards criminal behaviour within clients is not considered, and therefore agency theory is applied only to normal banking operations. This research is doing the opposite and only applying agency theory within criminal operations. This is the important difference of AML risk assessment; it is specifically about the risk from outside criminal behaviour.

⁴⁵⁷ Wright, P., Mukherji, A., & Kroll, M. J. (2001). A reexamination of agency theory assumptions: Extensions and extrapolations. *The Journal of Socio-Economics*, 30(5), 413-429

⁴⁵⁸ Hansen, L. (2013). “Gossip boys”: Insider trading and regulatory ambiguity. *Journal of Financial Crime*, 21(1), 29-43. doi:10.1108/jfc-04-2013-0030

⁴⁵⁹ Wright, P., Mukherji, A., & Kroll, M. J. (2001). A reexamination of agency theory assumptions: Extensions and extrapolations. *The Journal of Socio-Economics*, 30(5), 413-429 (p421)

3.3.4 Socio-economic Risk

Socio-economic risk is another risk area that criminologists have studied that may have some impact on money laundering recruitment. This is the sociological impact on criminal choice, which often according to strain theory explains how social and economic factors can influence why individuals choose to engage in criminal activity.⁴⁶⁰ This could therefore be applied to explain why certain countries with weaker and poorer economies are more susceptible to bribery and corruption related money laundering activity.

However, from a banking risk assessment perspective white collar crime is itself an anomaly since white collar criminals are not necessarily at the lower end of the socio-economic spectrum.⁴⁶¹ Money laundering may also offer other benefits to people such as enjoying the challenge of defrauding the system, as well as acquiring personal financial gain. Money laundering is also a necessity for other types of crime such as drug trafficking and piracy, and might not actually be considered as a white collar crime at all for the organisations behind the money. Therefore, risk matrices based on socio-economic factors are not really applicable because of the complex nature of the money laundering activity and the number of different skills required especially within complicated and large scale money laundering schemes.

⁴⁶⁰ Agnew, R., Piquero, N. L., & Cullen, F. T. (2009). General strain theory and white-collar crime. In *The criminology of white-collar crime* (pp. 35-60). Springer.

⁴⁶¹ Agnew, R., Piquero, N. L., & Cullen, F. T. (2009)

Socio-economic risk can be used by criminals to recruit and exploit people to join their money laundering operation and this can include the recruitment or acquisition of insider knowledge from banking officials.

3.3.5 Bribery and Corruption

The impact of money laundering on the banking sector has, until recently not necessarily been classed as a high priority in banking risk assessment, since it was not really considered the responsibility of the bank to determine where the money had originated from. However, this situation is changing and now money laundering can have a number of direct impacts on financial institutions.⁴⁶² One of the ways in which they can be directly affected is through staff corruption and exposure to bribery. Research into criminal motivation in white collar crime has shown that there is a relationship between increases in employee fraud and links to facilitating ML activity.⁴⁶³ Countries that are particularly susceptible to employee corruption are those where the economy is poor or volatile due to conflict and with higher poverty rates. In these situations, banking pay and conditions are often relatively low, coupled with financial and family pressures, which can make these individuals open to be bribed or coerced

⁴⁶² Amone, M & Borlini, L. (2010) "International Anti-Money Laundering Programs." J of Money Laundering Control 13, no. 3: doi:10.1108/13685201011057136.

⁴⁶³ Hansen, L. L. (2009). Corporate financial crime: Social diagnosis and treatment. Journal of Financial Crime, 16(1), 28-40. doi:10.1108/13590790910924948

to work for criminal gangs operating in the area. A socio-economic analysis is useful for understanding how primary loyalties influence choices in relation to engaging with criminal activity, and how social and familial pressures are all interlinked and can be exploited by criminal gangs seeking new recruits.

Despite the increased AML risks from certain countries there are also many cases that highlight how corruption is not solely restricted to emerging or developing economies. One prominent case that highlights this very clearly is the House Bank Affair⁴⁶⁴ where members of the US House of Representatives were involved in fraudulent activity including writing cheques to non-existent businesses. Preece et al., applied an agency theory model to determine how this situation arose and who was more likely to be involved in the activities of over cheque writing. They highlight that agency theory suggests where inappropriate measures or incentives are not provided to deter from engaging in criminal activity, agents will inevitably succumb to the profitability offered through the criminal route. Their research also highlighted that the longer the politicians had been in power the greater the chance that they would abuse the system.

Other developed countries have also highlighted examples of enquiries into their politicians' use of expense accounts and investigations

⁴⁶⁴ Preece, D. C., Mullineaux, D. J., Filbeck, G., & Dennis, S. A. (2004). Agency theory and the house bank affair. *Review of Financial Economics*, 13(3), 259-267. doi:10.1016/j.rfe.2003.09.00

into fraudulent claims.⁴⁶⁵ All of these situations illustrate that criminal motivation is not a cultural phenomenon that only applies in certain areas of the world. The application of agency theory⁴⁶⁶ as it is being used in this thesis implies that in certain situations most individuals will eventually succumb to seeking personal gain at the expense of others.⁴⁶⁷ There may however, be certain cultural factors that could be used to influence people not to engage in criminal activity, and these are considered more in the next section on systemic theories and corporate governance models.

3.3.6 Professional Launderers

The final agency relationship in money laundering systems is between the criminal and the professional money launderer. Although criminals do launder their own money some prefer to use the services of professional launderers, people who may work outside of the criminal business but also use their knowledge and expertise of the financial sector to facilitate money laundering activity.⁴⁶⁸ They describe this professional launderer as “*a third party agent, to whom criminals outsource their money*

⁴⁶⁵ICIJ (2015) Swiss leaks: Murky cash sheltered by bank secrecy <http://www.icij.org/project/swiss-leaks/banking-giant-hsbc-sheltered-murky-cash-linked-dictators-and-arms-dealers> accessed 2 March 2016

⁴⁶⁶Jensen, C., & Meckling, H. (1976). Theory of the firm: Managerial behaviour, agency costs and ownership structure. *Journal of Financial Economics*, 3, 305-360

⁴⁶⁷Wright, P., Mukherji, A., & Kroll, M. J. (2001). A reexamination of agency theory assumptions: Extensions and extrapolations. *The Journal of Socio-Economics*, 30(5), 413-429.

⁴⁶⁸McCarthy, K. J., van Santen, P., & Fiedler, I. (2014). Modelling the money launderer: Micro theoretical arguments on anti-money laundering policy. *International Review of Law and Economics*. doi:10.1016/j.irl.2014.04.00

laundrying needs.⁴⁶⁹ They develop this concept further into a theoretical model of a bargaining game, which they argue can be used to determine how AML regulation will ultimately impact on money laundering through these professional laundering services. Their findings support the work of Takats that increased fines not only dilute the quality of reporting being produced, as defensive reporting becomes the norm, but it also increases the demand for professional launderers and so increases the profitability for and temptation to enter this sector. A situation which McCarthy, van Santen, & Fiedler maintain will only expand the money laundering sector and not decrease the number of incidents as intended.⁴⁷⁰

3.4 Money Laundering & International Regulation

Money laundering, for many researchers is viewed primarily as an economic crime.⁴⁷¹ However, as mentioned in the previous section it can also be considered an international relations issue, due to the nature of its cross border transactions and support to political and criminal organisations across the globe. Within that international relations context global banks will remain a prominent financial service to money launderers since they have the capacity to move large amounts of money around the

⁴⁶⁹ McCarthy, K. J., van Santen, P., & Fiedler, I. (2014). Modelling the money launderer: Micro theoretical arguments on anti-money laundering policy. *International Review of Law and Economics*. doi:10.1016/j.irle.2014.04.00 (p2)

⁴⁷⁰ McCarthy et al. *ibid* p8

⁴⁷¹ Amone, M & Borlini, L. (2010) "International Anti-Money Laundering Programs." *J of Money Laundering Control* 13, no. 3: doi:10.1108/13685201011057136.

globe.⁴⁷² Another strategic and operational vulnerability that leaves global banks open to ML, is that they have branches in countries with less manageable AML procedures and where entry points into the bank, either through corruption or less streamlined monitoring, are easier for ML clients to access.⁴⁷³

3.4.1 Global Economic Implications of AML

Studies that have undertaken an economic analysis of international patterns of money laundering, have concluded that where AML measures are weak, criminals will tend to opt for easier ways of laundering money.⁴⁷⁴ Ironically TBML is more likely to be a risk to a bank that has strict AML measures in place, since the launderer will have to use more creative and complex mechanisms to bypass the regulation. This process has been explained economically by Masciandaro,⁴⁷⁵ as a principal-agent relationship between the regulator and the banks. In this model the increasing cost of regulation to match the complexity of criminal laundering and the overall economic environment are all factors that have to be considered when developing an appropriate AML model.⁴⁷⁶ According to

⁴⁷² Delston, R.S. and Walls, S.C. (2009), "Reaching beyond banks: how to target trade-based money laundering and terrorist financing outside the financial sector", *Case Western Reserve Journal of International Law*, Vol. 41 No. 1, pp. 85-118.

⁴⁷³ Mugarura, N. (2014). Customer Due Diligence (CDD) mandate and the propensity of its application as a global AML paradigm. *Journal of Money Laundering Control*, 17(1), 76-95.

⁴⁷⁴ Ferwerda, J. (2012). *The Multidisciplinary Economics of Money Laundering*. Printed by Ridderprint, Ridderkerk, Tjalling C. Koopmans Dissertation Series.

⁴⁷⁵ Masciandaro, D. (1999) 'Money Laundering: The Economics of Regulation', *European Journal of Law and Economics*, No. 3, May, pp. 245-240.

⁴⁷⁶ Pellegrina, L. D., & Masciandaro, D. (2008). The Risk Based Approach in the new European Anti-Money Laundering Legislation: A Law and Economics View. "Paolo Baffi" Centre Research Paper Series No. 2008-22, 1-24.

Pellegrina & Masicandaro, at some point it may not be economically viable for banks to constantly invest in regulation if criminals are only developing other ways to achieve their end result.

At a global level and in the context of international investment banking, criminal launderers also tend to move funds from developing countries into more stable developed economies.⁴⁷⁷ This causes a flow of illicit funds from developing economies, which in turn weakens and destabilises these regions even more.⁴⁷⁸ The importance of challenging and deterring ML activity is thus vitally important to banks and also to the whole country or state in which the bank operates. Perhaps this broader economic understanding of money laundering is now moving beyond the normal focus that banks place on reputational risk within their normal business operations. Now both banks and governments are having to think in broader corporate social responsibility concepts and strategies.

However, this approach and the resources that will be required may be considered as a luxury for countries that have weaker economies. *“it is argued that developing countries perceive money-laundering reforms as necessary to satisfy powerful outside interests rather than a policy that can deliver significant local benefits.”*⁴⁷⁹ In particular, banks and governance structures may see AML measures as supporting the work of law

⁴⁷⁷ Amone, M & Borlini, L. (2010) "International Anti-Money Laundering Programs." J of Money Laundering Control 13, no. 3: doi:10.1108/13685201011057136.

⁴⁷⁸ Kar, D., & LeBlanc, B. (2013). Illicit financial flows from developing countries 2002-2011

⁴⁷⁹ Sharman, J. C., & Chaikin, D. (2009). Corruption and anti-money-laundering systems: Putting a luxury good to work. Governance, 22(1), p29.

enforcement, rather than being of any direct benefit to the banks themselves. This particular corporate attitude would need to be challenged in future AML compliance systems, if an international response is to be successful and reach a global impact.

3.4.2 A Theoretical Perspective on Regulation

At another level it could be argued that the potential influence of national regulatory control is becoming of less relevance as AML takes on a global perspective and now requires a global AML response by both regulators and banks alike.⁴⁸⁰ Strategies to address money laundering need to become more strategic and applicable across the entire global banking context. There are two different theoretical perspectives to increasing regulation and describing the impact this will have on deterring money laundering activity. From a criminology perspective increased regulation tends to act as deterrent to criminal activity “*opportunities for crime appear to rise as regulation declines.*”⁴⁸¹ However, from a business perspective the corporate costs associated with compliance and regulation⁴⁸² as well as the cost to the bank of being a victim of corporate crime and/or facing fines for noncompliance issues, means that the money laundering is always going to be a costly business. As a result, larger organisations will be better able to absorb the costs of corporate crime and

⁴⁸⁰ O'Brien, J., & Dixon, O. (2013). Common link in failures and scandals at the world's leading banks, the. *Seattle University Law Review*, 19, 941-972

⁴⁸¹ Hansen, L. L. (2009). Corporate financial crime: Social diagnosis and treatment. *Journal of Financial Crime*, 16(1), 28-40. doi:10.1108/13590790910924948 (p32)

⁴⁸² Neilsen, G., & Furneaux, W. (2013). Financial crime: Compliance and failure. Retrieved from <http://www.bankingtech.com/57881/financial-crime-compliance-and-failure>

are therefore likely to be less affected by increased regulation.⁴⁸³ Applying Gottschalk's thinking further then smaller banks are unlikely to be able to afford any increase in regulatory costs and therefore weaknesses in the system will become inevitable.

There are also critics of changing the regulation too much as this itself can cause new problems especially for organisations such as banks that are running a business. This is opposed to the regulators who work for the state interests and therefore do not have to manage a business model in the application of their work. Both economists and criminologists have acknowledged that there needs to be a realistic understanding of the structure of business operations and over regulation will not be conducive to business growth *"Additionally, the prevention of corporate and elite crime is doomed to fail if regulation is the only applied solution. Business practices do not happen in an environment of strict regulation."*⁴⁸⁴ As an example of this Yeoh,⁴⁸⁵ describes the impact of some of the UK AML legislation that requires banks to freeze assets until SARs have been cleared. This act would then leave a potential loss of revenue to legitimate clients and increase pressure unnecessarily upon small businesses. Instead it would appear that AML systems require the use of both repression and prevention to shape ML strategies ⁴⁸⁶ as well as encouraging a stronger involvement and cooperation from the banks.

⁴⁸³ Gottschalk, P. (2013). White-Collar criminals in modern management

⁴⁸⁴ Hansen, L. L. (2009, p33)

⁴⁸⁵ Yeoh, P. (2014). Enhancing effectiveness of anti-money laundering laws through whistleblowing. J of Money Laundering Control, 17(3), 327-342. doi:10.1108/jmlc-06-2013-002

⁴⁸⁶ Amone, M & Borlini, L. (2010) "International Anti-Money Laundering Programs." J of Money Laundering Control 13, no. 3: doi:10.1108/13685201011057136.

Criminologists have also criticised the reactionary approach that regulators have currently taken to try to address ML crimes “*Regulation and prevention of elite corporate crime tends to be reactive rather than prophylactic in nature.*”⁴⁸⁷ This could also be linked to a lack of strategic and non-political control of AML regulation, which Hansen argues needs AML regulation to move beyond the current political arena which has so far prevented any consistent approach towards prosecuting corporate criminals. Demetis and Angell from a systemic analysis of ML suggest that this obsession by regulators, to try and control the ML risk situation through increased regulation, has largely been ineffective; a view that is also supported by proponents of agency theory.⁴⁸⁸ Individual countries have also highlighted weaknesses in their banking regime’s attempts to comply with the rules and regulations as stipulated by the regulators and domestic legislation.⁴⁸⁹ Finally, research into economic predictions of TBML have highlighted that where countries implement strong AML regulation, then incidents of TBML tend to be more prevalent.⁴⁹⁰ This could be as a result of crime displacement⁴⁹¹ in which criminals evolve their techniques for money laundering, in response to barriers placed in their way. The implications for banks are quite clear, whatever the reason

⁴⁸⁷ Hansen, L. L. (2009). Corporate financial crime: Social diagnosis and treatment. *Journal of Financial Crime*, 16(1), 28-40. doi:10.1108/13590790910924948 p32

⁴⁸⁸ Pellegrina, L. D., & Masciandaro, D. (2008). The Risk Based Approach in the new European Anti-Money Laundering Legislation: A Law and Economics View. “Paolo Baffi” Centre Research Paper Series No. 2008-22, 1-24.

⁴⁸⁹ Subbotina, N. (2009). Challenges that Russian banks face implementing the AML regulations. *J of Money Laundering Control*, 12(1), 19-32. doi:10.1108/136852

⁴⁹⁰ Ferwerda, J., Kattenberg, M., Chang, H., Unger, B., Groot, L., & Bikker, J. (2011). Gravity Models of Trade-based Money Laundering. Discussion paper 11-16 Tjalling C Koopmans research Institute, 1-23.

⁴⁹¹ Soudijn, M. (2014). A Critical Approach to Trade-Based Money Laundering. *Journal of Money Laundering Control* Vol 17, Iss 2, 230-242.

increased AML compliance is obviously not the only deterrent required to prevent TBML activity taking place.

3.4.3 Regulators

Within each country the responsibility for monitoring AML compliance is undertaken by local financial regulators. They are responsible for ensuring that both domestic and international AML regulation is adhered to within the banking sector. This can place the regulator in a strong influential role within the local banking context⁴⁹² or they can equally have a powerful effect as in the case of HBUS, if they choose not to intervene.⁴⁹³ From various pieces of research, it would appear that different banks and countries appear to have experienced different types of relationships depending on the influence and scope of the regulatory body. Subbotina looked specifically at the Russian banking context and found that regulators often provided little in the way of guidance, which was a major challenge since many of the AML laws were deemed to be lacking clarification and open to multiple interpretations, *“most of the interviewees agreed that as the AML laws are too flexible to different interpretation and basically do not explain what is allowed and*

⁴⁹² Subbotina, N. (2009). Challenges that Russian banks face implementing the AML regulations. *J of Money Laundering Control*, 12(1), 19-32. doi:10.1108/136852

⁴⁹³ O'Brien, J., & Dixon, O. (2013). Common link in failures and scandals at the world's leading banks, the. *Seattle University Law Review*, 19, 941-972

*what is not absolutely allowed.*⁴⁹⁴ Other researchers have looked at the Chinese banking sector⁴⁹⁵ and have again challenged the approach to money laundering⁴⁹⁶ and the lack of support or guidance being given to developing AML systems.⁴⁹⁷ Researchers appear to be consistently repeating the point that regulation alone cannot be viewed as the panacea to corporate and money laundering crime.⁴⁹⁸

3.4.4 International Regulatory Context

Global banks operate within an international AML regulatory framework that has directed domestic and regional responses. The international framework effectively started in the US with the introduction of the Bank Secrecy Act in 1970⁴⁹⁹ and then later with the UN Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances in 1988. Although combating the drugs trade and its associated cash profits started back in the 1960s⁵⁰⁰ there was no international legal framework until the 1988 UN Convention, also known as the Vienna Convention. The

⁴⁹⁴ Subbotina, N. (2009). Challenges that Russian banks face implementing the AML regulations. *J of Money Laundering Control*, 12(1), 19-32. doi:10.1108/136852 (p30)

⁴⁹⁵ Ai, L. (2012). "Rule based but risk oriented" approach for combating money laundering in Chinese financial sectors. *J of Money Laundering Control*, 15(2), 198-209. doi:10.1108/13685201211218225

⁴⁹⁶ Dongrong, L. (2005). China: Anti-money laundering in a foreign exchange area. *Journal of Money Laundering Control*, 8(4), 335-338.

⁴⁹⁷ Ai, L., Broome, J., & Yan, H. (2010). Carrying out a risk-based approach to AML in china: Partial or full implementation? *J of Money Laundering Control*, 13(4), 394-404. doi:10.1108/13685201011083894

⁴⁹⁸ Hansen, L. L. (2009). Corporate financial crime: Social diagnosis and treatment. *Journal of Financial Crime*, 16(1), 28-40. doi:10.1108/13590790910924948

⁴⁹⁹ Durrieu, R. (2013). *Rethinking money laundering & financing of terrorism in international law*. Boston: Martinus Nijhoff.

⁵⁰⁰ Delston, R.S. and Walls, S.C. (2009), "Reaching beyond banks: how to target trade-based money laundering and terrorist financing outside the financial sector", *Case Western Reserve Journal of International Law*, Vol. 41 No. 1, pp. 85-118.

Palermo Convention in 2000 focused specifically on combating Transnational Organised Crimes but also strengthened the money laundering aspect of the 1988 Convention.⁵⁰¹ Despite all this the Vienna Convention still remains the only hard law framework in existence for AML compliance although there have been a number of soft law guidelines that have been developed over the intervening years. Most notable are the FATF 40 recommendations on money laundering⁵⁰² and the 9 special recommendations on terrorist financing which have since been amalgamated, as well as the Wolfsberg principles.⁵⁰³ After the 9/11 attacks a special USA Patriot Act was also introduced in the US.

3.4.5 Global Banking Regulation

At an international level the main bodies who are responsible for monitoring and reporting on the international economic and banking issues, such as the IMF and the World Bank, have all endorsed the FATF guidelines and recommendations.⁵⁰⁴ Meanwhile from the banking regulation sector there have been guidelines produced from the Basel Committee on Banking Supervision and the Financial Conduct Authority⁵⁰⁵

⁵⁰¹ Mugarura, N. (2014). Customer Due Diligence (CDD) mandate and the propensity of its application as a global AML paradigm. *Journal of Money Laundering Control*, 17(1), 76-95.

⁵⁰² FATF. (2008). Best practices paper on trade based money laundering. Paris: FATF/OECD. Available from: <http://www.fatf-gafi.org/> [accessed 11th May 2015].

⁵⁰³ Wolfsberg Group (2011) Wolfsberg Trade Finance Principles. Retrieved from [http://www.wolfsberg-principles.com/pdf/standards/Wolfsberg_Trade_Principles_Paper_IL_\(2011\).pdf](http://www.wolfsberg-principles.com/pdf/standards/Wolfsberg_Trade_Principles_Paper_IL_(2011).pdf)

⁵⁰⁴ Camacho, A. R. (2013). Modelling the risk profiles of clients in the fight against money laundering and terrorism financing. *International Journal of Business and Economics*, 12(2), 97-120.

⁵⁰⁵ FCA. (2013). Bank's control of financial crime risks in trade finance. London: Financial Conduct Authority.

as well as specific stipulations in the US Patriot Act ⁵⁰⁶ for US based banking services. However, there is also agreement emerging from the financial services sector that AML regulation is struggling to stay ahead of money laundering activities.⁵⁰⁷ Some of the reasons behind this may be linked to the bank's perception of stricter regulation having an adverse effect on business growth, especially if suspicious reports are filed against certain countries or geographic regions.⁵⁰⁸ Other factors may be associated with the ever increasing compliance needs and resources and concern for the rising associated costs.⁵⁰⁹ Finally, as AML compliance has a stronger interest in protecting the overall financial system rather than the interests of particular banks. *"AML laws are not intended to protect bank customers or the bank; they safeguard the U.S. financial system and the nation as a whole,"*⁵¹⁰ this could be another factor as to why banks are struggling to find the link between compliance and a benefit to their own business.

⁵⁰⁶ Camacho, A. R. (2013). Modelling the risk profiles of clients in the fight against money laundering and terrorism financing. *International Journal of Business and Economics*, 12(2), 97-120.

⁵⁰⁷ Araujo, R, A (2010). "An Evolutionary Game Theory Approach to Combat Money Laundering." *Journal of Money Laundering Control* 13, no. 1

⁵⁰⁸ Masciandaro, D & Passarelli, F, (2013). "Taxation or regulation in preventing systemic risk? The political distortion," *BANCARIA*, Banca Editrice, vol. 4, pages 2-14, April.

⁵⁰⁹ Neilsen, G., & Furneaux, W. (2013). *Financial crime: Compliance and failure*. Retrieved from <http://www.bankingtech.com/57881/financial-crime-compliance-and-failure>

⁵¹⁰ Homeland Security. (2012). HSBC exposed US financial system to money laundering, drug, terrorist financing risks. From permanent sub committee on investigations. US Senate. Retrieved from <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/us-vulnerabilities-to-money-laundering-drugs-and-terrorist-financing-hsbc-case-history> accessed 4 August 2015 p339

3.5 Banking Regulation & Responses

One of the main challenges facing banks is, according to Masciandaro ⁵¹¹ a principal-agent relationship between the regulators on the Principal side and the banks as Agents on the other. The regulatory response so far has largely been to increase the level of compliance and reporting requirements. This has forced the banking sector to increase the number of reports submitted to FIUs, which has subsequently caused a decrease in the efficiency of these units, which are now inundated with undiscerning risk reports. ⁵¹² However, this approach also has to be considered against the impact of increased costs due to regulatory demand versus the limited and often decreasing resources available to many small businesses and organisations working within the financial services. The latter point is also an ongoing challenge to the banking sector ⁵¹³ and needs to be considered when deciding to expand or encourage more reporting in banking AML models.

Banks also have a principal-agent relationship with their clients and may sometimes be pulled between the two roles. However, it could be argued that this makes the assumption that money laundering is purely an economic activity since agency theory is primarily an economic analysis.

⁵¹¹ Masciandaro, D. (1999) 'Money Laundering: The Economics of Regulation', *European Journal of Law and Economics*, No. 3, May, pp. 245-240.

⁵¹² Ferwerda, J. (2012). *The Multidisciplinary Economics of Money Laundering*. Printed by Ridderprint, Ridderkerk, Tjalling C. Koopmans Dissertation Series.

⁵¹³ Pellegrina, L. D., & Masciandaro, D. (2008). *The Risk Based Approach in the new European Anti-Money Laundering Legislation: A Law and Economics View*. "Paolo Baffi" Centre Research Paper Series No. 2008-22, 1-24.

Although this is partly true, money laundering is also a banking phenomenon that has additional business and also in this context, criminal implications. From the banking perspective this means that to some extent the systemic effectiveness of information sharing systems and communication mechanisms, across banks and within banking structures, also need to be considered within any theoretical analysis. Finally, from the criminal perspective the changes in banking practice will have implications for how money laundering schemes will continue to develop and evolve; since it will require increased expertise and knowledge to bypass new regulations. In essence without this level of behavioural understanding, trying to develop risk based frameworks will be futile.

3.5.1 Regulation and Information Gathering

Many of the theoretical frameworks exploring AML regulation and banking compliance have focused either specifically on the Agency-Principal relationships between the regulators and the banks⁵¹⁴ or the decision-making balance required in managing the risk taking behaviour of the client against the risk aversion behaviour of the regulators.⁵¹⁵ This framework also considers these two prominent areas of discussion but in addition it examines other applications of agency theory, including

⁵¹⁴ Takáts, E. (2007). A theory of "crying wolf": The economics of money laundering enforcement. Ana Lucia Coronel. IMF Working Paper.

Pellegrina, L. D., & Masciandaro, D. (2008).

⁵¹⁵ Macey, J. (1991) "Agency Theory and the Criminal Liability of Corporations." Faculty Scholarship Series. Paper 1716: 315-340. http://digitalcommons.law.yale.edu/fss_papers/1716.

between professional launderers and criminals.⁵¹⁶ Professional launderers are often accountants or trained legal practitioners, who are familiar with Anti-money laundering (AML) regulation and compliance requirements and can develop schemes that by pass many of the current AML systems.⁵¹⁷

The current response from financial regulators towards the issue of money laundering, has tended to focus on increasing the amount and monitoring the implementation of compliance regulation. Their aim has been to try and stamp out money laundering through a process of intelligence gathering and reporting of suspicious transaction patterns or Customer Due Diligence information.⁵¹⁸ However, risk based approaches to money laundering cannot continue to operate within a model of ever increasing information, as theories of information overload and intelligence gathering will attest to. In other words, there has to be a system of reviewing and evaluating the value of the information gathered if it is to remain useful to risk assessment. Too much information can actually produce less rather than more intelligence, since the ability of both individuals and organisations to process information is limiting.⁵¹⁹ An effective system for making risk decisions based upon information sharing and the prioritisation of this information, requires a filter system to be developed within financial institutions.

⁵¹⁶ McCarthy, K. J., van Santen, P., & Fiedler, I. (2014). Modelling the money launderer: Micro theoretical arguments on anti-money laundering policy. *International Review of Law and Economics*. doi:10.1016/j.irl.2014.04.00

⁵¹⁷ McCarthy, K. J., van Santen, P., & Fiedler, I. (2014).

⁵¹⁸ Mugarura, N. (2014). Customer Due Diligence (CDD) mandate and the propensity of its application as a global AML paradigm. *Journal of Money Laundering Control*, 17(1), 76-95.

⁵¹⁹ Jones, Q., Ravid, G., & Rafaeli, S. (2004). Information overload and the message dynamics of online interaction spaces: A theoretical model and empirical exploration. *Information Systems Research*, 15(2), 194-210

The impact of weak information screening can be seen in the older systems of AML processes, which mainly used rule based risk assessment frameworks. These systems tended to focus on compliance regulations and checklists using *“precise rules and hence legal certainty, but it also encourages formalistic over-reporting.”*⁵²⁰ Although rule based assessments require less information to be processed, since the information requirements are clearly defined, they are also open to missing information if it is not explicitly included on the checklists. An additional problem that arises when regulatory reporting requirements are increased, is that weaker rules based assessment reports will be used as these are often quicker to implement and require less time to complete, resulting in an overload of risk reports and a fear of internal risk assessment in case regulators deem them inadequate.⁵²¹

3.5.2 Assessing Financial Intelligence Data

All banking structures across the globe, regardless of which type of risk assessment system is used, have to pass on the alert information onto national Financial Intelligence Units (FIUs) for further processing and

⁵²⁰ Unger, B., & van Waarden, F. (2009). How to dodge drowning in data? Rule- and risk-based anti money laundering policies compared. *Review of Law & Economics*, 5(2). doi:10.2202/1555-5879.142 (p954)

⁵²¹ Takáts, E. (2007). A theory of "crying wolf": The economics of money laundering enforcement. Ana Lucia Corofnel. IMF Working Paper

analysis.⁵²² The effectiveness of these FIUs depends on the quality of the information received from the banks. From these units' suspicious information can be passed directly onto law enforcement agencies if required. There is the need to filter information in order to determine the presence and categorisation of suspicious activity⁵²³ and to ensure that the FIUs will not be overwhelmed with too much undiscerning information from banks that are failing to administer their own internal risk assessment processes. It should therefore be assumed that any underlying theoretical framework, for AML risk based approaches, would need to incorporate a theoretical perspective of the limitations of information understanding and analysis, as well as the impact of reporting requirements on bank behaviour (agent response).

3.5.3 Bank Responses to Regulation

According to research most responses to AML risk have been led by financial regulation bodies, rather than as a result of initiatives led by the banking sector.⁵²⁴ This provides a valuable insight into the theoretical context of the working relationship between banks and regulators. In order to understand the nature of this relationship further Araujo applied game theory to analyse the banking response to implementing new AML

⁵²² Camacho, A. R. (2013). Modelling the risk profiles of clients in the fight against money laundering and terrorism financing. *International Journal of Business and Economics*, 12(2), 97-120.

⁵²³ Cindori, S. (2013). Money laundering: Correlation between risk assessment and suspicious transactions. *Financial Theory & Practice*, 37(2), 181-206.

⁵²⁴ Camacho, A. R. (2013). Modelling the risk profiles of clients in the fight against money laundering and terrorism financing. *International Journal of Business and Economics*, 12(2), 97-120.

approaches, as well as to understand the decision-making process as to how and when banks decide to implement AML regulation. Araujo discovered that banks decide whether to implement AML regulation as a business decision and often assess whether the costs of compliance are deemed too high, compared to the penalty costs of non-compliance. The Agent-Principal relationship is still applied but game theory results have tended to indicate that increasing the penalty fines is the only way to ensure that banks uphold compliance requirements because it is the cheaper option compared to being caught.⁵²⁵

In other research the impact of regulatory responses on changes in criminal behaviour and ML crimes have been noted. The changing pattern of criminals' behaviour to better adapt to their situation has been described by criminologists as *crime displacement*, although other authors have also challenged its existence.⁵²⁶

Despite being questioned by some researchers as a guaranteed criminal behaviour change it has been witnessed as a phenomenon within the money laundering sector. In part the reason that TBML has become such an emerging area of concern for the financial and trade sectors, is precisely because criminal syndicates have responded to the increase in AML regulation by creating these newer and more complex schemes in order to bypass the regulation. As many of the AML systems within banks

⁵²⁵ Araujo, R, A (2010). "An Evolutionary Game Theory Approach to Combat Money Laundering." *Journal of Money Laundering Control* 13, no. 1

⁵²⁶ Soudijn, M. (2014). A Critical Approach to Trade-Based Money Laundering. *Journal of Money Laundering Control* Vol 17, Iss 2, 230-242.

and financial services have developed and become more efficient they can detect the more traditional sources of ML such as cash smuggling and the use of financial institutions own ingenious systems to bypass or circumvent the new regulation or they will get caught.

Another example of the application of a game theoretical framework can be to analyse the way in which banks have responded to the increased pressure from regulators to complete suspicious alerts and reports, in order to avoid both civil and criminal liability charges.⁵²⁷ The response of the banks has mainly included trying to avoid costly fines by over reporting suspicious transactions and inundating financial intelligence units with huge amounts of un cleansed data.⁵²⁸ This has now resulted in a situation whereby minor concerns and suspicions cannot be differentiated from the more serious offences. This effect of over reporting has been described in a separate economic theory of ML enforcement, known as the 'Crying Wolf theory' ⁵²⁹ and expanded upon in work by other economists as a predictable outcome from too much regulatory pressure.⁵³⁰ Increased penalties and fines can therefore increase reporting, but this can also be a double edged sword. More information is not necessarily better information or useful information.

⁵²⁷ Delston, R.S. and Walls, S.C. (2009), "Reaching beyond banks: how to target trade-based money laundering and terrorist financing outside the financial sector", *Case Western Reserve Journal of International Law*, Vol. 41 No. 1, pp. 85-118.

⁵²⁸ Ferwerda, J. (2012). *The Multidisciplinary Economics of Money Laundering*. Printed by Ridderprint, Ridderkerk, Tjalling C. Koopmans Dissertation Series.

⁵²⁹ Takáts, E. (2007). A theory of "crying wolf": The economics of money laundering enforcement. Ana Lucia Corofnel. IMF Working Paper

⁵³⁰ Unger, B., & van Waarden, F. (2009). How to dodge drowning in data? Rule- and risk-based anti money laundering policies compared. *Review of Law & Economics*, 5(2). doi:10.2202/1555-5879.142

According to O'Brien & Dixon the recent spate of cases in which banks and their regulators have been questioned, suggests that a fundamental reform is required in order to rebuild public confidence and trust in the banking and regulatory sectors. The HSBC whistle blower Hervè Falciani suggested that other bodies including NGOs should play a role in monitoring rather than relying on a centralised unit. This proposal is not without its limitations since many NGOs by their very nature operate outside any formal state body. Groups such as Global Financial Integrity⁵³¹ have produced major research reports focusing specifically on known illicit financial flows in countries such as Russia, as well as other developing countries.⁵³² Other organisations such as the International Consortium of Investigative Journalists (ICIJ)⁵³³ have undertaken their own investigations into known criminals and identified how illicit funds are being moved around the globe, which has highlighted gaps in the current banking system. This information might be deemed unsubstantiated but it can certainly be used as soft evidence to inform risk assessment reviews within the banking sector.⁵³⁴ However, banks adapt their risk assessment processes, the financial regulation sector is constantly having to evolve in order to meet the global and practical challenges, emerging in the banking and financial services sectors.⁵³⁵ Although there are not going to be simple solutions there are some models that have been suggested such as the

⁵³¹Kar, D., & Freitas, S. (2013). Russia illicit financial flows and the role of the underground economy. Global Financial Integrity.

⁵³²Kar, D., & Spanjers, J. (2014). Illicit financial flows from developing countries 2003-2012

⁵³³<https://www.icij.org/>

⁵³⁴Pozzebon, S. (2015) HSBC whistle blower: You have to know how banks work to understand just how big this scandal is UK Business Insider <http://uk.businessinsider.com/interview-with-herv-falciani-hsbc-2015-2?r=US> accessed 20 February 2015

⁵³⁵O'Brien, J., & Dixon, O. (2013). Common link in failures and scandals at the world's leading banks, the. Seattle University Law Review, 19, 941-972

CEDAR approach to AML, which is a broader framework for developing an AML system “*the five core dimensions of the CEDAR frame-work: compliance, ethics, deterrence, accountability, and risk.*”⁵³⁶ A new approach such as this considers AML as being beyond just a regulatory requirement and instead focuses on it being a fundamental part of the overall ethos and accountability structure of the bank and its governance model.

3.6 Risk Assessment

Although Agency theory is considered in this research to be the primary theoretical framework there are other theories that can further inform some of the agency relationships. Systemic risk theories consider some of the broader organisational influences that can affect risk assessment. These could include methods of communication and information sharing across businesses or as in this research within the banking structure. In Angell & Demetis’s work⁵³⁷ they use systems theory to explain AML responses and highlight how AML regulation will never be the ‘solution’ but will be part of the decision-making process of trying to curb money laundering activity.

⁵³⁶ O'Brien, J., & Dixon, O. (2013, p971)

⁵³⁷ Angell, I. O., & Demetis, D. S. (2005). Systems thinking about anti-money laundering considering the Greek case. *Journal of Money Laundering Control*, 8(3), 271.

3.6.1 Systemic AML Risk

Since risk assessment is seen as a key element of corporate governance⁵³⁸ then it seems logical that some form of systemic understanding of AML compliance and risk assessment is needed by the management structure, including internal audit. The challenge that most banks are faced with is how to simplify the definition of risk, within the AML risk assessment approach.⁵³⁹

Systemic risk is often broken down into a series of specific types of risk e.g. financial risk or legal risk etc. which Angell & Demetis argue simply confuses the situation and misses the point. The point being that risk by its very nature is about uncertainty and cannot therefore be categorised into independent and isolated headings. Instead the work of Angell & Demetis considers the AML system slightly differently to the standard analysis of organisational risk. They do not look at the banking system per se, instead they define a systems theory approach to AML by considering AML as one system, one that is based on activities that are either suspicious or non-suspicious.

This whole systemic approach to AML is interesting. If a systemic approach just applied to the banking structure, then it would not

⁵³⁸ Mihret, D. G. (2014). How can we explain internal auditing? The inadequacy of agency theory and a labour process alternative. *Critical Perspectives on Accounting*, 25(8), 771-782. doi:10.1016/j.cpa.2014.01.00

⁵³⁹ Demetis, D. S., & Angell, I. O. (2007). The risk-based approach to AML: Representation, paradox, and the 3rd directive. *J of Money Laundering Control*, 10(4), 412-428. doi:10.1108/1368520071083090

necessarily incorporate all the factors that AML compliance would be affected by. In particular, the bank's relationship to regulation would not necessarily be incorporated into such an analysis and it is the structural elements of the regulatory bodies and their inherent relationship with the banks that is a key driving component for effective regulatory risk based approaches. Evidence of the impact of this system can be seen in further detail in the HBUS analysis, which is discussed in the next chapter.

White collar crime analysts would also provide a systemic analysis to the criminal aspect of money laundering, and would also consider the influences of the broader economic and structural factors, such as capitalism.⁵⁴⁰ In particular criminologists have used a theoretical understanding of capitalism to explain how regulation has failed especially within the larger banks, that are now viewed as underpinning much of the global economy⁵⁴¹ and are in essence 'too big to jail'.⁵⁴² This level of structural analysis is important but at the same time is beyond the scope of this research project. Instead elements of systems approaches will be applied to the criminal motivation area of the framework. The points raised by Angell and Demetis in relation to AML being its own system will be considered in the data analysis section.

⁵⁴⁰ Barak, G. (2013). Flickering desires for white-collar crime studies in the post-financial crisis: Will they ever shine brightly, the. In W. Criminology rev (Vol. 14, p. 61). HeinOnline

⁵⁴¹ Barak, G. (2013)

⁵⁴² Gongloff, Mark. (2013). "Eric Holder Admits Some Banks Are Just Too Big to Prosecute" March 6, Retrieved [Jan 21, 2015] http://www.huffingtonpost.com/2013/03/06/eric-holder-banks-toobig_n_2821741.html

Finally, one of the effects of increased regulation and reporting is that an efficient and transparent system of data collection and information sharing is needed, otherwise individual units within the banking system will become overwhelmed with data. Unfortunately, modern risk based approaches for money laundering can produce high quantities of data which in turn require advanced systems of filtering and data cleansing, to determine the type and categorisation of suspicious activity.⁵⁴³ This is a situation that seems likely to continue to be problem, given that a recent report from PwC ⁵⁴⁴ (2014) on TBML stated that improved data was one of the main issues in the TBML detection race. The research analysis of AML risk assessment process needs to be operationalised across the whole bank at some point and therefore does have systemic risk implications.⁵⁴⁵ However, this research is instead seeking to contribute towards expanding the knowledge and understanding of TBML activity first; rather than immediately developing a systemic approach, although there will be contributions made to this discussion as well.

⁵⁴³ Cindori, S. (2013). Money laundering: Correlation between risk assessment and suspicious transactions. *Financial Theory & Practice*, 37(2), 181-206.

⁵⁴⁴ PwC. (2014). Goods gone bad. Addressing money-laundering risk in the trade finance system.

⁵⁴⁵ McConnell. (2013). Systemic operational risk - the LIBOR manipulation scandal. *Journal of Operational Risk*, 8(3), 59-99

3.6.2 HSBC Bank in the United States of America (HBUS)

During the course of this thesis a number of legal court cases and media investigations became public. These cases provided an opportunity to analyse and assess what was currently happening in the banking system with AML regulation.

As an empirical example the HSBC case has provided some interesting insights into regulatory and banking relationships. As one of the largest global banking structures HSBC has a number of interesting factors about its case. Firstly, it is one of the largest financial institutions in the world, “...with over \$2.5 trillion in assets, 89 million customers, 300,000 employees, and 2011 profits of nearly \$22 billion.”⁵⁴⁶ It has operations in over 80 countries, with several hundred affiliate associations across the globe. The US section of HSBC known as HBUS, operates over 470 bank branches throughout the country with an estimated 3.8 million customers. Therefore, given the size of its business operations and global reach then inevitably the size of its AML problems are going to be bigger than most other financial institutions. The HSBC Swiss private bank is one of the largest private banks in the world “With USD382 billion of total assets under management, HSBC Private Bank is one of the largest international private banks.”⁵⁴⁷

⁵⁴⁶ Homeland Security. (2012). HSBC exposed US financial system to money laundering, drug, terrorist financing risks. From permanent sub committee on investigations. US Senate. Retrieved from <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/us-vulnerabilities-to-money-laundering-drugs-and-terrorist-financing-hsbc-case-history> accessed 4 August 2015 p5

⁵⁴⁷ HSBC Private Bank (2015) <http://www.hsbcprivatebank.com>

As part of their investigation into HBUS the Permanent Subcommittee on Investigations raised a number of concerns in relation to the AML compliance standards at the bank. These included a lack of action in dealing with suspicious alerts within the bank; a lack of communication across different branches of the bank including with HSBC in London and HBMX in Mexico, as well as issues that were wrongly risk assessed or misunderstood by HBUS. The situation in HSBC Switzerland also reflected a lack of communication between different affiliate branches as well as the use of banks in different jurisdictions to complete fraudulent transactions including tax evasion and possible money laundering. In both cases there was a corporate downplaying of the risks to the bank of being associated with fraudulent activity.

3.6.2.1 HBUS Investigation

In their report the Permanent Subcommittee investigation focused on five areas of irregularity in AML compliance ⁵⁴⁸ which all revolved around the cross border transfer of funds. The five areas were the lack of appropriate risk classification for affiliate banks, the risky use of bulk travellers' cheques and bearer accounts, failing to file suspicious reports to the FIU and overriding the OFAC filters for dealing with countries

⁵⁴⁸ Homeland Security. (2012).

designated as high risk. Details of each of the five headings are discussed in more detail below.

3.6.3 Affiliate Banks

The report found that high risk affiliates banks such as Mexico were not acknowledged as high risk and were categorised as low risk options. This meant that banking trade continued as normal despite the well-publicised issues of drug trafficking, off shore dollar accounts and the high amount of cash deposits made through the affiliate service.

“...it had high risk clients, such as Mexican casas de cambios and U.S. money service businesses; and it offered high risk products, such as U.S. dollar accounts in the Cayman Islands.”⁵⁴⁹

The report also identified specific concern over HBMX as the HSBC affiliate in Mexico. In addition to its high risk location as a country known for drug related activities and criminal gangs, HMBX had a history of severe AML deficiencies. These included a lack of know Your Customer (KYC) information in client files especially for high profile clients who were known to be involved in drug trafficking. In addition, millions of dollars were

⁵⁴⁹ Homeland Security. (2012). HSBC exposed US financial system to money laundering, drug, terrorist financing risks. From permanent sub committee on investigations. US Senate. Retrieved from <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/us-vulnerabilities-to-money-laundering-drugs-and-terrorist-financing-hsbc-case-history> accessed 4 August 2015 p4

being cleared through bulk travellers' cheque transactions each year. In addition to these findings other issues were also identified which included

“...bankers who resisted closing accounts despite evidence of suspicious activity; inadequate staffing and resources; and a huge backlog of accounts marked for closure due to suspicious activity, but whose closures were delayed.”⁵⁵⁰

The HBSC group in London was aware of the difficulties in Mexico and had been working with them for a number of years to try and strengthen the weaknesses. It did not however, enlighten its US affiliate HBUS of this situation.⁵⁵¹

“For eight years, from 2002 to 2010, HSBC Group oversaw efforts to correct HBMX's AML deficiencies, while those efforts fell short. At the same time, HSBC Group watched HBMX utilize its U.S. correspondent account, without alerting HBUS to the AML risks it was incurring.”⁵⁵²

It also did not question the classification of Mexico as a low risk country despite a number of reports on the ongoing situation and risks connected to banking and the Mexican economy. Despite the lack of information from the parent company HSBC, the risk classification processes for HBUS were still clearly inadequate for the situations being

⁵⁵⁰ Homeland Security. (2012,p5)

⁵⁵¹ Homeland Security. (2012,p5)

⁵⁵² Homeland Security. (2012,p5)

faced and lacked any independent research into patterns of current economic activities in the countries being used.

3.6.4 High Risk Countries

The U.S. Treasury Department's Office of Foreign Assets Control (OFAC) has developed a list of prohibited persons and countries which banks use to create an "OFAC filter", to identify and halt potentially prohibited transactions. These US government safeguards are designed to stop terrorist activities and drug activity as well as money laundering but were circumvented within HBUS. This had the effect of ensuring that those countries that posed a high risk of terrorist and criminal activities were not named on transaction data, because otherwise it could lead to delays in processing the transaction due to the extra AML checks that were needed.

This example highlights some of the main potential problems in risk assessment strategies, when the impact of AML compliance starts to negatively affect business relations between the bank and clients. Some of the common tactics that the banks used to avoid such filters included stripping information from wire transfer documentation to conceal the participation of a prohibited person or country. Other methods included characterising a transaction as a transfer between banks in approved jurisdictions, while omitting underlying payment details that would disclose participation of a prohibited originator or beneficiary.

“At HBUS, documents provided to the Subcommittee indicate that, for years, some HSBC affiliates took action to circumvent the OFAC filter when sending OFAC sensitive transactions through their U.S. dollar correspondent accounts at HBUS. From at least 2001 to 2007, two HSBC affiliates, HSBC Europe (HBEU) and HSBC Middle East (HBME), repeatedly sent U-turn transactions through HBUS without disclosing links to Iran, even though they knew HBUS required full transparency to process U-turns.”⁵⁵³

As well as AML regulations examples of terrorist financing links were also disregarded as pressure was placed on HBUS by banks in Saudi Arabia and Bangladesh to continue operating their service there despite being named as high risk.⁵⁵⁴ In terms of a link back to agency theory ⁵⁵⁵ banks are responding to pressure from either side in their Principal – Agent- Client relationship. This has implications for how AML changes and risk assessment strategies are developed in the future. For example, if the bank does not see a distinct advantage to increasing their investment in AML compliance, then banking practices and common omissions will render the whole process useless.

⁵⁵³Homeland Security. (2012). HSBC exposed US financial system to money laundering, drug, terrorist financing risks. From permanent sub committee on investigations: . US Senate. Retrieved from <http://www.hsgac.senate.gov/subcommittees/investigations/media/hsbc-exposed-us-financial-system-to-money-laundering-drug-terrorist-financing-risks> p5

⁵⁵⁴Homeland Security. (2012). HSBC exposed US financial system to money laundering, drug, terrorist financing risks. From permanent sub committee on investigations. US Senate. Retrieved from <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/us-vulnerabilities-to-money-laundering-drugs-and-terrorist-financing-hsbc-case-history> accessed 4 August 2015

⁵⁵⁵Macey, J. (1991). Agency theory and the criminal liability of corporations. Faculty Scholarship Series.,Paper 1716, 315-340. Retrieved from http://digitalcommons.law.yale.edu/fss_papers/1716

3.6.5 Bulk Travellers' Cheques

The use of travellers' cheques to facilitate money laundering was another risk that HBUS overlooked. Instead the bank was found to have cleared \$290 million in bulk travellers' cheques, often with consecutive serial numbers through its correspondent bank in Japan. This was determined by law enforcement to have benefited Russian criminal gangs who were disguising money laundering through the importation of used cars.

*"..the Japanese bank had little KYC information or understanding why up to \$500,000 or more in bulk U.S. dollar travellers cheques purchased in Russia were being deposited on a daily basis into one of 30 different Japanese accounts."*⁵⁵⁶

3.6.6 Bearer Share Accounts

HBUS was found to have offered more than 2,000 bearer share accounts to customers despite the high risk of money laundering due to

⁵⁵⁶ Homeland Security. (2012). HSBC exposed US financial system to money laundering, drug, terrorist financing risks. From permanent sub committee on investigations. US Senate. Retrieved from <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/us-vulnerabilities-to-money-laundering-drugs-and-terrorist-financing-hsbc-case-history> accessed 4 August 2015 p7

the anonymity of the accounts. *“HBUS’ Miami office had over 1,670 bearer share accounts and generated annual bank revenues of \$26 million.”*⁵⁵⁷

3.6.7 Suspicious Alerts

HBUS did have an AML system in place that recorded red flag alerts internally in the bank. These alerts needed to be analysed by the AML section within HBUS, to decide whether further investigation by outside agencies was required. However, a lack of resources and a high level of staff turnover meant that, at the time of the investigation, there was a backlog of over 17,000 un-reviewed alerts. Many of these alerts identified potentially suspicious activities that needed to be passed onto the appropriate financial investigation unit and law enforcement bodies.

3.6.8 Risk Assessment

One of the key services, in the battle against money laundering, that banks perform is the filing of suspicious activity reports (SARs). These reports serve three main purposes; the disruption of crime; to bring money launderers to justice and thirdly to recover the proceeds of crime.⁵⁵⁸ They

⁵⁵⁷ Homeland Security. (2012,p7)

⁵⁵⁸ Yeoh, P. (2014). Enhancing effectiveness of anti-money laundering laws through whistleblowing. *J of Money Laundering Control*, 17(3), 327-342. doi:10.1108/jmlc-06-2013-002

are the link between the banking sector which witnesses the transactions and law enforcement who can prosecute the criminals. The motivation to complete and return these reports is provided through the regulators, since banks are not necessarily interested per se in working closely with law enforcement as part of their business. However, none of the examples listed through the HSBC cases could be considered as implementing the SAR system as intended.

3.6.9 OCC

Throughout the time period covered by the investigation into HBUS, the financial regulator that was responsible for overseeing the bank's activities was the Office for the Comptroller of the Currency (OCC) which is an independent bureau of the U.S. Department of the Treasury. Although a number of concerns had been raised by the Office of the Comptroller of the Currency (OCC), since 2002 regarding HBUS and their AML responses, it was not until 2010 that the OCC finally, issued a supervisory letter outlining a series of very serious concerns and AML weaknesses within the bank. Following this letter, a Cease and Desist Order was then issued in the following month, October 2010. There has been stringent criticism of the way in which the OCC operated, the Permanent Subcommittee report openly stated their disappointment "*They were tolerant of the bank's weak AML program, too slow in reacting to repeat deficiencies, and failed to make prompt use of available*

enforcement tools."⁵⁵⁹ Other researchers have also highlighted the lack of engagement by the OCC even when blatant AML practices were being thwarted.⁵⁶⁰

One of the key findings in the PSI report, in relation to the regulator, emerged from the Permanent Subcommittee investigation after they examined how money laundering compliance risk was classified by the OCC. The investigation discovered that many of the AML breaches that occurred within HBUS were then subsequently classified as client risks rather than business risks to the bank. This classification system was contrary to the practices of other regulatory bodies at the time and it was possible the PSI report claimed, that this could be part of the overall problem that allowed the HBUS situation to escalate. Consequently, the OCC had identified over 80 matters requiring attention within a five-year period, but none of these individually were classified as violating federal AML law. In other words, the AML risks were not viewed as a threat to the bank's capacity to operate and other factors such as weak governance and corporate social responsibility policies were not considered at all, in their risk assessment framework. It was only when the whole AML programme was found to be a problem that the OCC finally recognised it as a legal violation.

⁵⁵⁹ Homeland Security. (2012). HSBC exposed US financial system to money laundering, drug, terrorist financing risks. From permanent sub committee on investigations. US Senate. Retrieved from <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/us-vulnerabilities-to-money-laundering-drugs-and-terrorist-financing-hsbc-case-history> accessed 4 August 2015 (p128)

⁵⁶⁰ O'Brien, J., & Dixon, O. (2013)

Many of the challenges identified in the HBUS case ultimately became the responsibility of the governance structure of the bank. Poor decision making was one of the issues identified in the report,⁵⁶¹ although this was further hampered by poor advice provided by the regulatory body (OCC) who failed to adequately inform the management and governance bodies of the risks the bank was being exposed to. The key to an effective corporate governance structure involves strong and clear internal reporting and monitoring, which according to Seal should be fully embedded into the organisation. In terms of AML oversight, the US Federal Deposit Insurance Corporation “*Section 36 requires that banks establish an independent audit committee, and that they report annually on ‘Management Responsibility for Financial Statements and Internal Controls,’*”⁵⁶² although only banks with assets greater than \$500 million are subject to this ruling, for economic efficiency reasons. However, the HBUS and HSBC Swiss bank cases both had AML structures in place, the difficulty was how they operated alongside other governance priorities and what lobbying and influential strength they had compared to other priorities within the bank.

⁵⁶¹ Homeland Security. (2012). HSBC exposed US financial system to money laundering, drug, terrorist financing risks. From permanent sub committee on investigations. US Senate. Retrieved from <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/us-vulnerabilities-to-money-laundering-drugs-and-terrorist-financing-hsbc-case-history> accessed 4 August 2015

⁵⁶² Altamuro, J., & Beatty, A. (2010). How does internal control regulation affect financial reporting? *Journal of Accounting and Economics*, 49(1-2), p60

3.6.10 Governance Implications

The situation in HSBC stemmed from a weak working definition of operational risk, which was restricted to the definition used by Basel II, which was defined solely as legal risk; rather than reputational or strategic risk.⁵⁶³ Although operational risk or is a key component of the governance role of a bank it can cover a multitude of different things. If, however, the only focus, for the governance structure are legal ramifications, then this explains the apparent lack of concern by HBUS. In their case the regulator's decision was to classify the AML discrepancies of HBUS as client risks, which were classified as reputational or strategic risks, and subsequently perceived to have no legal binding. By the time the regulator had realised the severity of the situation and allowed the bank's exposure to escalate to one of legal risk it was too late for the governance structure to avoid legal consequences.

⁵⁶³ McConnell. (2013). Systemic operational risk - the LIBOR manipulation scandal. *Journal of Operational Risk*, 8(3), 59-99

3.6.11 HSBC in the US

The HSBC case highlighted a number of ways in which AML compliance was not prioritized within the governance structure of the bank. Instead the following observations were noted ⁵⁶⁴ about the case whereby it could be assumed that;

1. AML was viewed as a client issue and not a bank concern (view supported by financial regulator).
2. Suspicious Alerts were viewed as an external compliance issue rather than a tool for risk assessment in the bank, therefore were given a lower priority.
3. Advice from internal audit not heeded, not received, or not actually produced.
4. Acceptance of bulk cash into banking system, regardless of the purpose or suspected activity of the client.
5. Acceptance of bulk traveller's cheques not seen as suspicious or the alerts were never processed.
6. Unquestioning acceptance of affiliate banks and their AML risk assessment procedures, regardless of the country risk status, or evidence from research that contradicted this acceptance.

⁵⁶⁴Homeland Security. (2012). HSBC exposed US financial system to money laundering, drug, terrorist financing risks. From permanent sub committee on investigations: . US Senate. Retrieved from <http://www.hsgac.senate.gov/subcommittees/investigations/media/hsbc-exposed-us-financial-system-to-money-laundering-drug-terrorist-financing-risks>

Most of these factors are reflection of a banking cultural attitude towards AML regulation. Similar findings were noted in the following Swiss HSBC case.

3.6.12 HSBC Switzerland

The HSBC Swiss bank case came to the media attention at the beginning of 2015 raising a number of red flags regarding anti-money laundering (AML) practices within the banking sector. In particular, the weak risk assessment systems meant that the banking sector was either directly or inadvertently playing a role in supporting or facilitating financial crime activities, especially since their risk systems were operating from a position of only dealing with the money and were not considering the source or intent of their client's activities. The main focus of the media reports in the HSBC Swiss case was on tax evasion and the loss of monies to EU governments and other developed economies. However, the International Consortium of Investigative Journalists (ICIJ) ⁵⁶⁵ discovered through the leaked data files, that the Swiss HSBC bank had a number of clients who were residents of developing countries. These clients were able to move illicit money from developing economies into Switzerland and from there onto offshore financial havens, thus depriving

⁵⁶⁵ICIJ (2015) Swiss leaks: Murky cash sheltered by bank secrecy <http://www.icij.org/project/swiss-leaks/banking-giant-hsbc-sheltered-murky-cash-linked-dictators-and-arms-dealers> accessed 2 March 2015

their own country's development and hindering aid and government assistance programmes within these countries.⁵⁶⁶

In another case that involved the HSBC, this time in the Swiss private banking sector, the corporate attitude or CA was illustrated through the complicit and supportive role it played in facilitating clients to avoid tax and use the bank to move monies into off shore tax havens. The source of money being deposited into the bank was not viewed as a concern to the bank at that time, so the suspicions that clients were engaging in illegal activities to acquire the funds such as arms smuggling or diamond smuggling⁵⁶⁷ were not challenged or reported.

AML compliance was thus seen through a very restrictive lens, which focused exclusively on the basic criteria of filling forms and tick boxes whilst the wider purpose of preventing money laundering was clearly not a priority for the governance model at that time. Another example of indiscriminative form filling was the labelling of most woman business clients as 'housewives' on the beneficial ownership information.⁵⁶⁸ This according to the ICIJ investigation appeared to be the default setting when other information was unknown or had not been completed. This was despite several of the client files being for established

⁵⁶⁶Kar, D., & LeBlanc, B. (2013). Illicit financial flows from developing countries 2002-2011. Washington, DC: GFI. Retrieved from http://iff.gfintegrity.org/iff2013/Illicit_Financial_Flows_from_Developing_Countries_2002-2011-HighRes.pdf

⁵⁶⁷ICIJ (2015) Swiss leaks: Murky cash sheltered by bank secrecy <http://www.icij.org/project/swiss-leaks/banking-giant-hsbc-sheltered-murky-cash-linked-dictators-and-arms-dealers> accessed 2 March 2015

⁵⁶⁸Fitzgibbon, W (2015) The Real 'Housewives' of HSBC <http://www.icij.org/project/swiss-leaks/real-housewives-hsbc> accessed 1st January 2016

professionals including business owners, teachers and journalists. This illustrated either a significant lack of attention to detail or it supposed a deliberate neglect in gathering appropriate levels of information on each client.

This also raises the question as to what is the purpose of AML regulation, is it to control the behaviour of banks or should it have a broader role in raising awareness of the risks that are associated with money laundering activity, and the wider social impact that this can cause? The examples illustrated here show that the basic compliance work was not being strictly adhered to which implies that further action from the regulators is needed. This could be a combination of approaches, including stricter enforcement, closer monitoring and feedback and also providing additional support and training to explain why the information is needed.

There were a number of difficulties in both the HSBC situations. However, O'Brien and Dixon summed up the global problem with the bank at this time "*The global failure of compliance and oversight suggests deep structural problems with HSBC's core business model.*"⁵⁶⁹ This might be construed as a simplistic analysis given HSBC position as an international bank trying to operate across multiple jurisdictions. However, other investigations into HSBC have also identified structural inadequacies such as limited knowledge of client business transactions and BOI, a lack of

⁵⁶⁹ O'Brien, J., & Dixon, O. (2013). Common link in failures and scandals at the world's leading banks, the. *Seattle University Law Review*, 19, (p959)

inter- bank communication on AML and a culture of minimizing risk assessment systems.

In that business model AML compliance was not a feature and as a result a number of standard procedures and red flag alerts that could have prevented a court case occurring were ignored. In particular, within HBUS the internal audit function should ideally have developed a risk assessment system that addressed all the following issues:

1. Red flag indicators for suspicious activity should have included bulk cash transfers.
2. Customer due diligence should have been undertaken on clients from Mexico, regardless of the affiliate bank's process for administering checks.
3. The implications of not adequately dealing with suspicious alerts needed to have been clearly communicated to governance, auditors and the regulatory bodies.
4. The allocation of country risk status should have been based on research and an understanding of the activities that could have been occurring to generate these funds.
5. The broader social implications of being involved in facilitating criminal activities should have been highlighted to the governance structure and the risk to the bank emphasised, rather than assuming a position based solely on client risk.
6. Corporate social responsibility should have questioned the activities that the bank was funding.

In the HSBC Swiss bank, the following issues that arose could perhaps have been raised through internal audits and AML audit reports:

1. CDD checks - to be widened to include international checklists such as UN.
2. The bank's governance model - towards AML processes such as introducing a rule of not accepting or supporting clients who were using the bank to avoid and evade tax requirements.
3. Stronger Politically Exposed Persons` (PEP) checks - which would have required more detailed background information on client's professional background and family contacts / businesses.
4. Filing SARs - AML audits could have identified areas where SARs were not accurately filed with all with full information included.
5. Beneficial ownership information - audits could have identified where clients were involved in a number of different companies and the relationship between each of these companies.

The two cases identified here in the academic review section provide some level of insight into the challenges and current situation that many AML units are facing with regard to auditing AML compliance issues. There appears to be the lack of a cohesive strategy across most banks that links together the main players of AML compliance, internal audit, external audit and the audit committee, and finally, to the management and governance structures. The size and scope of international money laundering does not appear to be reflected in the current level of resources

and management given to managing money laundering risk within the banking structure.

It is within this context that I sought to learn more about the techniques of TBML, and to begin to develop an understanding of how TBML activity can possibly occur undetected within the modern banking structure. The cases highlighted in this chapter and obtained through the media coverage and publicly available reports, such as the Homeland Security investigation, provide some valuable insights into how money laundering risks were not really understood, even within the larger global banks.

The next stage for the research was to establish to what extent banking risk assessment gaps from the mid-2000s were still issues that were relevant to modern risk assessment systems for AML and TBML.

The next section of the research process describes how information was gathered directly from banking personnel and associated professionals, to ascertain how accurate the literature analysis was in describing the current AML/ TBML detection issues. The research needed to determine how TBML was presenting as an issue within banking risk assessment, and what areas needed to be improved or reinforced in the AML sector.

CHAPTER 4 METHODOLOGY

4.1 Introduction

The methodology section describes the design process of the research. It identifies the main questions that the research wants answered and explains why the methods used were chosen. As part of this section different theories were discussed that might explain why things in money laundering practices actually occur.

This section of the research presents the methodological approach adopted by the research and explains the underlying belief system that influenced the research design. The entire research process was guided by the development of a research framework and the first part of this section describes how the research framework was established.

The aim of the research project was further refined and is '*to examine and explore options for a risk/ control framework that applied to TBML clients and their transactions, when they are within the banking domain.*' The purpose that was identified for the research, was that it would explore and then generate, a detailed picture of how TBML transactions manifest within the banking context. From this information the findings would be used to determine what role realistically the banking sector could play in intervening and ultimately stopping these actions.

The main gap that the research questions identified was the need to develop a greater level of insight and understanding of TBML and to apply or develop an appropriate theoretical and empirical framework.⁵⁷⁰ This framework needed to be developed for both future academic research, especially in the area of risk assessment in banking, as well as for developing practical recommendations for AML staff and internal audit function / governance structures.

4.2 Research problem

The problem therefore that the research was seeking to explore was the need to develop a deeper understanding of TBML risk analysis and to make recommendations linked to enhancing or improving current TBML detection within the financial services sector. Most of the issues which are being explored, in this research are specific to the banking domain, although the implications of the results have the potential to influence wider academic and empirical discussion.

One of the challenges facing the research design was to ensure that the results would provide a valuable and unique academic contribution. This was in addition to being considered alongside other high quality practice based research within the banking sector. Quality research

⁵⁷⁰ Östlund, U., Kidd, L., Wengström, Y., & Rowa-Dewar, N. (2011). Combining qualitative and quantitative research within mixed method research designs: A methodological review. *International Journal of Nursing Studies*, 48(3), 369-83. doi:10.1016/j.ijnurstu.2010.10.00

within banking is especially important in order to explore the practical and current events facing those actually working in the sector; a process that has been described as moving accountancy and banking into the realm of scientific practices.⁵⁷¹ Whilst empirical research moves functions as part of the academic and scientific realm those engaging in it also need to be mindful that it remains relevant to current everyday practice and does not alienate those that it is trying to support, through inappropriate language and overly complex academic and theoretical explanations.

This research project was seeking to understand a broadly empirical situation i.e., TBML detection within a banking context, but it is also linking this empirical situation into an academic and theoretical context.⁵⁷² This has been done in order to develop an appropriate theoretical framework⁵⁷³ in which to interpret the findings and provide an explanation for the activities observed. In developing the research framework for this project this balance between practice and theory⁵⁷⁴ has hopefully been maintained, by including both sets of issues throughout each of the main sections of the project, including the literature review, methodology framework and data collection and analysis.

⁵⁷¹ Nørreklit, H., Nørreklit, L., Mitchell, F., & Bjørnenak, T. (2012). The rise of the balanced scorecard! Relevance regained? *J Acc & Organizational Change*, 8(4), 490-510. doi:10.1108/1832591121127349

⁵⁷² Cameron, R. (2011). Mixed methods research: The five ps framework. *The Electronic Journal of Business Research Methods*, 9(2), 96-108

⁵⁷³ Udo-Akang, D. (2012). Theoretical constructs, concepts, and applications. *American International Journal of Contemporary Research*, 2(9), 89-97.

⁵⁷⁴ Verstegen, B. H. J. (2001). Nine ways for a decision maker to use theoretical notions, with special reference to teaching agency theory for management accounting. *Journal of Accounting Education*, 19(2), 119-127

4.2.1 Research Framework - Overview

The research framework was broadly based upon the model developed by Saunders⁵⁷⁵ known as the research onion model. In this model Saunders describes how research consists of different layers that constitute the beliefs and values underpinning the research. From these outer layers a methodology can be designed to suit the beliefs until finally, at the centre of the 'onion' model there is the data collection. The original model shows six actual layers which are;

1. Philosophical stance
2. Approaches
3. Strategies
4. Choices
5. Time Horizons
6. Techniques and procedures

The adapted model used in this research is a more integrated version shown in the diagram below (Figure 3).

⁵⁷⁵ Saunders, M., Lewis, P., & Thornhill, A. (2007). *Research Methods for Business Students*, (6th ed.) London: Pearson.

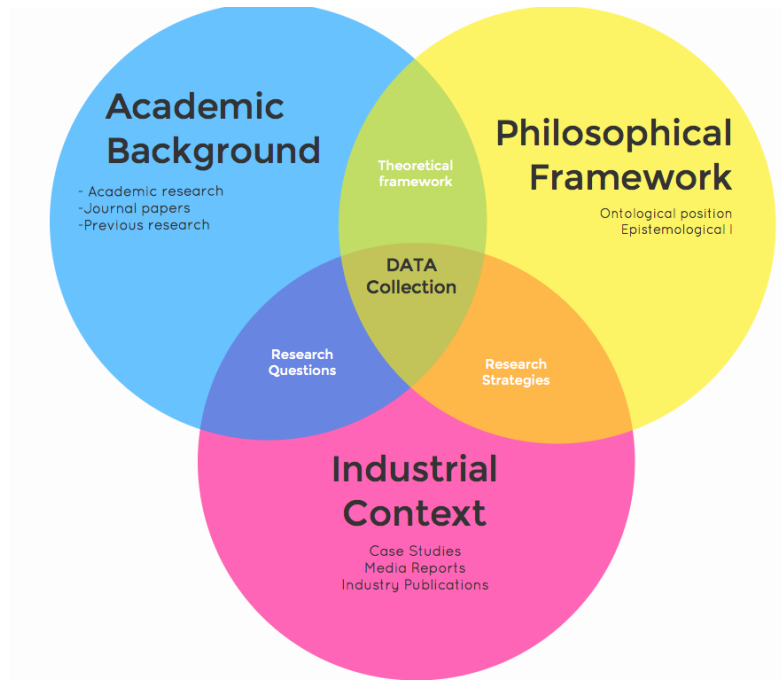


Figure 3–TBML research model - Adaptation of the Onion Model

For this research project the onion model has been adapted slightly and is used more as a guiding template rather than a rigid structure. The reason for the adaptation is due to the nature of this research, which is an exploratory piece of work, rather than an experimental model which might be better suited to the rigid outline of the onion model. However, the key components remain the same including the research philosophy, ontological position, epistemological position, data collection methods and timescale.

4.3 Philosophical Stance

The philosophical stance is outlined below and comprises three main sections the ontological position that the project is operating from; the underlying epistemological beliefs in relation to TBML and thirdly the philosophic set of assumptions that have been used or developed in the process of exploring this topic.

4.3.1 Ontological Position

An ontological position essentially offers an explanation of the research context and how the research interprets the contextual background to the topic. The research contextual framework in this study is underpinned by an ontological belief that TBML transactions are complex social and financial processes that occur across both the formal and informal banking sectors.⁵⁷⁶ In this research project a position has been adopted that these TBML transactions will continue to constantly evolve in complexity, which is partly as a response to the nature of regulation and AML monitoring that is being developed within the banking structures.⁵⁷⁷ Some of the other complexities are also outlined in the sub sections below. The research is thus established within a very naturalistic

⁵⁷⁶ Ferwerda, J. (2012). *The Multidisciplinary Economics of Money Laundering*. Printed by Ridderprint, Ridderkerk, Tjalling C. Koopmans Dissertation Series.

⁵⁷⁷ McCarthy, K. J., van Santen, P., & Fiedler, I. (2014). Modelling the money launderer: Micro theoretical arguments on anti-money laundering policy. *International Review of Law and Economics*. doi:10.1016/j.irle.2014.04.00

setting⁵⁷⁸ of the banking environment and has tried to maintain a research framework, both empirically and theoretically, that acknowledges the reality of the 'real banking situation'.

"In naturalist settings, realities are wholes that cannot be understood in isolation from their contexts."⁵⁷⁹

In the context of this particular research a naturalistic environment also means that every observation at a local banking level needs to be constantly related to the larger world of organised crime and transnational and international money laundering. This will enable a truer understanding of TBML to be acquired because it is a crime that occurs at an international level, with local banks only involved at certain points in the process. The research strategy has developed the following positions in relation to how TBML transactions currently present themselves within the banking context.

4.3.2 Global Money Transfer

The research position believes that following TBML transactions is a complex process, since the activities and transactions occur at a global level and involve a number of different agencies working together, including law enforcement, financial intelligence and auditing services,

⁵⁷⁸ Glaser, B. G. (2003). Naturalist inquiry and grounded theory. *Forum Qualitative Sozialforschung / Forum: Qualitative Social Research*, 5(1), 1-14

⁵⁷⁹ Glaser (2003, p3)

banking representatives from AML, business units and management and also custom and tax officials.⁵⁸⁰ Despite this complexity banks have to constantly apply risk assessment strategies for TBML activities, even though they may be doing so without knowing the full context and background of the monies involved. Given the current range and scope of global financial services that banks offer, this research project is also assuming that criminals will continue to operate within the formal financial services sector, including banking, until they are stopped or strongly discouraged.⁵⁸¹

4.3.3 Risk Based Approach

Within current Money Laundering risk assessment frameworks there has been a gradual evolvement and change in approach from a strictly rules based process, where definite criteria were looked for and checked, to a more flexible and increasingly complex risk based approach. The risk based approach acknowledges the increasing variety in ML techniques that can be used, and the different ways in which these might present within a banking context.⁵⁸² Instead of definitive lists the banks are encouraged to develop their own system of detecting risk, working within and including their own specific perimeters, including country risk, client risk, business risk and other factors pertinent to the region in which they

⁵⁸⁰ Ferwerda, J. (2012). *The Multidisciplinary Economics of Money Laundering*. Printed by Ridderprint, Ridderkerk, Tjalling C. Koopmans Dissertation Series.

⁵⁸¹ Hansen, L. L. (2009). Corporate financial crime: Social diagnosis and treatment. *Journal of Financial Crime*, 16(1), 28-40. doi:10.1108/13590790910924948

⁵⁸² FATF. (2008). *Trade based money laundering*. France. Financial Action Task Force

operate. Global banks are finding this process to be especially challenging when they have branches located across many different jurisdictions, all of which face localised challenges that can be very different in relation to money laundering risks and are therefore not easy to coordinate at a central level.

4.3.4 Vulnerabilities and Entry Points into the Financial Sector

The increasing cost of maintaining and updating AML compliance and regulation demands has reached a point where many smaller banks and financial institutions are unable to offer full protection against some of the bigger ML schemes.⁵⁸³ This makes them especially vulnerable as entry points into the financial services sector, where laundered money can be first placed into the financial system. Larger banks will then face the challenge of being used as institutions through which launderers choose to integrate funds and will receive the laundered money as transfers from other banks and financial services, which is harder to detect, rather than catching launderers as they place the initial money into the system. The pattern of ML is thus constantly changing with the weakest points in the financial services sector being constantly identified and exploited by launderers.

⁵⁸³ Neilsen, G., & Furneaux, W. (2013). Financial crime: Compliance and failure. Retrieved from <http://www.bankingtech.com/57881/financial-crime-compliance-and-failure>

The research is therefore focused on exploring those elements that will constitute a successful risk based approach, which is specific to the global banking context. The research questions have been designed to be practical in their approach and are exploratory in nature to try and determine how TBML can appear within a banking context.

4.3.5 Epistemological Position

An epistemological position is a statement of understanding about the knowledge we have on the topic of TBML. It is a summary position of the underlying values and beliefs that the project holds in relation to how TBML operations exist and how the research believes they are facilitated within the banking sector. This position has evolved out of the literature analysis⁵⁸⁴ and is underpinned by the theoretical framework, which was also developed as part of the literature review. In this research the underlying belief is that the bank will continue to operate as a profit orientated business even when faced with a possible money laundering threat, i.e. the primary concern is the future viability and profit of the bank. This is the application of an agency theory approach⁵⁸⁵ whereby the first priority to be addressed is the bank's self-preservation and operational success, rather than working on behalf of other outside agencies such as regulators or law enforcement agencies.

⁵⁸⁴ Zdanowicz, J. S. (2009). Trade-Based money laundering and terrorist financing. *Review of Law & Economics*, 5(2). doi:10.2202/1555-5879.1419

⁵⁸⁵ Pellegrina, L. D., & Masciandaro, D. (2008). The Risk Based Approach in the new European Anti-Money Laundering Legislation: A Law and Economics View. "Paolo Baffi" Centre Research Paper Series No. 2008-22, 1-24.

4.3.6 Dual Agency Role

Before the increased focus on regulation and AML compliance, the banks' primary focus had traditionally been to provide business support as an agent for the client, even if that client was involved in a criminal process (TBML). Nowadays this position is in obvious conflict to the other increasing role of the bank, which is to act as a regulatory agent for the state and international anti-money laundering monitoring and control authorities. The bank effectively has a dual agency role between supporting the client and meeting the demands of the regulator.⁵⁸⁶

The epistemological understanding is important to the research when considering how to develop a realistic and workable risk assessment framework for AML within banks, since the nature of this dual agency (Client vs Regulator) dilemma has to be acknowledged.⁵⁸⁷ The research is therefore seeking to determine whether the nature of this dual agency conflict can be understood and described in an academic context, and whether the data gathered in the research can be used as part of the development of a more in-depth understanding of the TBML process.

4.3.7 Application to Risk Assessment

⁵⁸⁶ Araujo, Ricardo Azevedo (2010). "An Evolutionary Game Theory Approach to Combat Money Laundering." *Journal of Money Laundering Control* 13, no. 1

⁵⁸⁷ Araujo (2010)

The research aims to develop an in-depth understanding of TBML⁵⁸⁸ and the dual agency role of the banking sector.⁵⁸⁹ It will achieve this primarily through the data collection, but there will also be acquired knowledge from exploring issues raised within both the empirical and theoretical documents from the banking and financial criminology⁵⁹⁰ industries. This includes building on and critiquing the traditional AML risk assessment frameworks⁵⁹¹ which have been developed largely by analysing observed typologies e.g. AUSTRAC (2014).⁵⁹² These typologies have been developed using sanitised case studies of actual reported TBML and ML cases and from these a system⁵⁹³ of identifying red flags have been created that can be used by organisations and the banking sector to spot similar types of potential ML cases. The cases are also used to look for patterns of behaviour, before applying these empirical observations directly into the banking context. In addition to industry reports there have been a number of media and investigative journalism

⁵⁸⁸Buehn, A., & Eichler, S. (2011). Trade misinvoicing: The dark side of world trade. *The World Economy*, 34(8), 1263-1287.

⁵⁸⁹Pellegrina, L. D., & Masciandaro, D. (2008). The Risk Based Approach in the new European Anti-Money Laundering Legislation: A Law and Economics View. "Paolo Baffi" Centre Research Paper Series No. 2008-22, 1-24.

⁵⁹⁰Hansen, L. L. (2009). Corporate financial crime: Social diagnosis and treatment. *Journal of Financial Crime*, 16(1), 28-40. doi:10.1108/13590790910924948

⁵⁹¹Sullivan, C., & Smith, E. (2011). Trade based money laundering- risks and regulatory responses. Australia: Australian Institute of Criminology. Retrieved from http://aic.gov.au/media_library/publications/rpp/rpp115.pdf

⁵⁹²AUSTRAC. (2014). Typologies and case studies report 2014. Australia: AUSTRAC. "AUSTRAC spends \$2.5m on Exadata upgrade" <https://www.crn.com.au/news/austrac-spends-25m-on-exadata-upgrade-268344>

⁵⁹³"Australian Government Contract Notices" Tender Detailing. Available at: <https://www.tenders.gov.au/?event=public.advancedsearch.CN&SONRedirect&type=cnEvent&atmType=archived%2Cclosed%2Cpublished%2Cproposed&agencyUUID=0EC900DB-D645-6C40-DD8BEA03CC15D392&agencyStatus=0&portfolioUUID=&keyword=Oracle&KeywordTypeSearch=AllWord&CNID=&dateType=Publish+Date&dateStart=&dateEnd=&supplierName=&supplierABN=&valueFrom=&valueTo=&ATMID=&AgencyRefId=&consultancy=&submit=Search>

reports that have emerged during the course of this research.⁵⁹⁴ These have shed some light into banking practices and AML compliance over the last few years and have added a legislative perspective⁵⁹⁵ to risk assessment frameworks.

This research also aims to expand this current knowledge base by seeking to use both the theoretical discussions and the empirical data, to establish patterns of AML compliance, and to consider whether these could work in future banking contexts. This knowledge could then be applied further afield and into the more complex situations of global and multi-banking TBML.

4.4 Research - Theoretical Framework

In this research project the theoretical framework is based upon Agency Theory and has been used to explain and predict the relationships that operate between the different partners involved in trade-based money laundering. In particular, the framework was used to consider three types of agency partnership; between the bank and the client, between the bank and the regulator and lastly between the criminal organization / client and a professional money launderer. The framework was specifically applied to

⁵⁹⁴ICIJ (2015) Swiss leaks: Murky cash sheltered by bank secrecy <http://www.icij.org/project/swiss-leaks/banking-giant-hsbc-sheltered-murky-cash-linked-dictators-and-arms-dealers> accessed 2 March 2015

⁵⁹⁵Homeland Security. (2012). HSBC exposed US financial system to money laundering, drug, terrorist financing risks. From permanent sub committee on investigations. US Senate. Retrieved from <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/us-vulnerabilities-to-money-laundering-drugs-and-terrorist-financing-hsbc-case-history>

a risk assessment context, with the expectation that the findings could then be unilaterally applied across all the banking, financial and regulatory services.

4.4.1 Framework

Within academic work there are a number of theoretical frameworks that have been used during the analysis of money laundering (ML), However, most of this work has been built around economic frameworks, in particular those that have been used either to predict ML growth ⁵⁹⁶ or manage ML data.⁵⁹⁷ This research however is not a pure economic project, it is focused on the behavioural aspect of money laundering responses and therefore a broader theoretical framework was needed and subsequently developed.

The research theoretical framework needed to be located within a clear empirical context that was directly relevant to the banking sector. It also needed to serve within the management and auditing functions especially of larger investment and global banks, whilst also remaining

⁵⁹⁶ Walker, J., & Unger, B. (2009). Measuring global money laundering: "The walker gravity model". *Review of Law & Economics*, 5(2). doi:10.2202/1555-5879.1418
laundering policies compared. *Review of Law & Economics*, 5(2). doi:10.2202/1555-5879.142
Ferwerda, J. (2012). *The Multidisciplinary Economics of Money Laundering*. Printed by Ridderprint, Ridderkerk, Tjalling C. Koopmans Dissertation Series.

⁵⁹⁷ Unger, B., & van Waarden, F. (2009). How to dodge drowning in data? Rule- and risk-based anti money laundering policies compared. *Review of Law & Economics*, 5(2). doi:10.2202/1555-5879.142

relevant to the smaller financial institutions. Since the banking sector is only concerned with the risk assessment and detection of money laundering, rather than the wider global economic impact of money laundering, then the focus of the research theoretical framework was concentrated specifically on the influences of banking risk assessment.

The framework that has been developed is a multi-theoretical framework. It has used the general economic theory Agency Theory as a base but has merged into this some of the specific agency related theories associated with the different banking relationships between clients, banks and regulators. This has included a third dimension, which is to include perspectives from the field of criminology, in order to incorporate a better understanding of the client's criminal behaviour. This latter point has been included because the research is working from a position that in order for risk assessment to be effective, banking staff need to have an understanding of the contextual situation of TBML and that includes criminal motivation as well as the typology of TBML transactions.

One of the challenges for all research is ensuring that the theoretical framework is relevant and appropriate to the study and to ensure that researcher bias does not overly influence the format of this framework.⁵⁹⁸ Even in the design choice of a multi-disciplinary framework there will still be elements of theoretical discourse that are excluded since

⁵⁹⁸ Modell, S. (2009). In defence of triangulation: A critical realist approach to mixed methods research in management accounting. *Management Accounting Research*, 20(3), 208-221. doi:10.1016/j.mar.2009.04.001

*“Theories are themselves human constructions and thus potentially fallible.”*⁵⁹⁹ In the next section the choice behind the design decisions are explained further.

4.5 Agency Theory

Agency theory works from the premise that a cooperative and economic relationship exists when one individual (a principal) gives authority to another individual (an agent) to act on their behalf in financial transactions.⁶⁰⁰ However, the goals of the principal and the agent are not necessarily mutually agreeable as each is working from their own agenda.⁶⁰¹ So a contract is established to try and ensure that the agent, despite their own business interests, will still work to secure the best advantage for the principal. Agency theory has also been developed to consider the potential conflict and risk associated between companies/banks seeking to develop profit for themselves,⁶⁰² possibly at the expense of their clients' gain.⁶⁰³

⁵⁹⁹ Modell (2009, p2214)

⁶⁰⁰ Wright, P., Mukherji, A., & Kroll, M. J. (2001). A reexamination of agency theory assumptions: Extensions and extrapolations. *The Journal of Socio-Economics*, 30(5), 413-429

⁶⁰¹ Wright, P., & Mukherji, A. (1999). Inside the firm: Socioeconomic versus agency perspectives on firm competitiveness. *The Journal of Socio-Economics*, 28(3), 295-307

⁶⁰² Jensen, C., & Meckling, H. (1976). Theory of the firm: Managerial behaviour, agency costs and ownership structure. *Journal of Financial Economics*, 3, 305-360.

⁶⁰³ Eisenhardt, M. (1989). Agency theory: An assessment and review. *Academy of Management. The Academy of Management Review*, 14(1), 57-74.

Preece, D. C., Mullineaux, D. J., Filbeck, G., & Dennis, S. A. (2004). Agency theory and the house bank affair. *Review of Financial Economics*, 13(3), 259-267. doi:10.1016/j.rfe.2003.09.008

In this typical principal-agent relationship the agent is often considered to be risk averse⁶⁰⁴ and will work⁶⁰⁵ to secure the business in this case the bank, over attaining individual principal wealth. This dynamic is deemed to be predictable within economic decision making and has been applied to operational risk scenarios in organisations, such as the theory of the firm.⁶⁰⁶ However, other authors⁶⁰⁷ have challenged the notion that agents cannot be risk loving or risk seeking, and state that risk seeking should be expected as the norm, especially given the organisational culture of risk in which many agents operate.

4.5.1 TBML & Agency Theory

For TBML transactions the agency theory model has been developed beyond organisational principal-agent relationships, to consider the relationships between banks and regulators and in particular the outside constraints imposed on banks through regulation.⁶⁰⁸ Other work by Macey (1991)⁶⁰⁹ applies agency theory in the analysis of corporate criminal cases. This research highlights the balance required by businesses in undertaking risk assessment, in particular between working and managing

⁶⁰⁴Wright, P., Mukherji, A., & Kroll, M. J. (2001). A reexamination of agency theory assumptions: Extensions and extrapolations. *The Journal of Socio-Economics*, 30(5), 413-429

⁶⁰⁵Jensen, C., & Meckling, H. (1976). Theory of the firm: Managerial behaviour, agency costs and ownership structure. *Journal of Financial Economics*, 3, 305-360.

⁶⁰⁶Jensen, C., & Meckling, H. (1976). Theory of the firm: Managerial behaviour, agency costs and ownership structure. *Journal of Financial Economics*, 3, 305-360.

⁶⁰⁷Wright, P., Mukherji, A., & Kroll, M. J. (2001). A reexamination of agency theory assumptions: Extensions and extrapolations. *The Journal of Socio-Economics*, 30(5), 413-429

⁶⁰⁸Pellegrina, L. D., & Masciandaro, D. (2008). The Risk Based Approach in the new European Anti-Money Laundering Legislation: A Law and Economics View. "Paolo Baffi" Centre Research Paper Series No. 2008-22, 1-24.

⁶⁰⁹Macey, J. (1991). Agency theory and the criminal liability of corporations. *Faculty Scholarship Series*, Paper 1716, 315-340. Retrieved from http://digitalcommons.law.yale.edu/fss_papers/1716

the risk taking behaviour of the client, against the risk aversion behaviour of the regulators, whilst all the time trying to maintain a profitable corporate business. However, Macey ⁶¹⁰ cites a clear warning after the findings from his research highlighted that a culture of risk avoidance may emerge rather than risk assessment. This defensive approach to monitoring and considering risk Macey claims, will undermine and discourages any form of creative thinking and innovative AML responses.

*“Applying basic principles of agency theory to the issue of criminal sanctions yields two insights. First, corporate officers and directors have a natural proclivity to refrain from taking risks. Engaging in criminal activity is a form of risk-taking. Excessive enforcement can exacerbate this proclivity toward excessive risk avoidance, in turn, stifling innovation and creativity and leading to a general decline in social wealth.”*⁶¹¹

In their work on agency theory McCarthy, van Santen, & Fiedler, (2014) also state that criminals and professional launderers act in a rationale Principal-Agent relationship, whereby both sides will make a series of choices depending on the situation presented to them. The agency relationship between the criminal and launderer also to some extent mirrors the agency relationship between the bank and the regulator ⁶¹² so that increased regulation in the banking sector will reduce the

⁶¹⁰ Macey, J. (1991) "Agency Theory and the Criminal Liability of Corporations." Faculty Scholarship Series. Paper 1716: 315-340. http://digitalcommons.law.yale.edu/fss_papers/1716.

⁶¹¹ Ibid p319

⁶¹² Macey, J. R. (1991). Agency theory and the criminal liability of organizations. BUL Rev., 71, 315.

willingness of banks to take risks. This in turn means that professional launderers can charge more in their fees because the job is more difficult, which in turn increases the viability for rogue bank officials to turn to money laundering as a viable risk.⁶¹³ So that the more complex the regulation procedures the more innovative the launderer must be to avoid them and the greater the cost to the criminal to pay for this level of expertise. However, McCarthy, van Santen, & Fiedler, (2014) predict in their model that increased regulation and more complicated laundering processes will actually build a market amongst professional launderers and encourage greater corruption options because the financial rewards will increase. Within this research project which is covering the complexity of TBML transactions, their research will become very relevant, as according to their work ⁶¹⁴ professional launderers are possibly already involved in money laundering in order to facilitate many of the TBML schemes in existence.

4.5.2 Agency Theory & Other Theoretical Frameworks

There are critics of agency theory such as Wright, Mukherji & Kroll,⁶¹⁵ who claim that the focus of agency theory is too narrow. This can

⁶¹³ McCarthy, K. J., van Santen, P., & Fiedler, I. (2014). Modeling the money launderer: Microtheoretical arguments on anti-money laundering policy. *International Review of Law and Economics*. doi:10.1016/j.irl.2014.04.006

⁶¹⁴ McCarthy, K. J., van Santen, P., & Fiedler, I. (2014). Modelling the money launderer: Micro theoretical arguments on anti-money laundering policy. *International Review of Law and Economics*. doi:10.1016/j.irl.2014.04.006

⁶¹⁵ Wright, P., Mukherji, A., & Kroll, M. J. (2001). A reexamination of agency theory assumptions: Extensions and extrapolations. *The Journal of Socio-Economics*, 30(5), 413-429

work for very specific cases,⁶¹⁶ but they were more concerned because they claim that the theory only deals with individual relationships, and the nature of these relationships are not really predictable because external conditions and environments can cause changes in the behaviour of individuals. However, most behavioural theories look at individual relationships and apply these broadly across the general population, so in that regard agency theory is no different.

Wright & Mukherji (1999)⁶¹⁷ acknowledge that the main weakness for them of agency theory is how it is applied to the broader concept of the firm,⁶¹⁸ rather than the narrow focus of the theory itself. As information for this project therefore, it is important that the theoretical framework to be used, if it is to be centred around agency theory, would need to stay within the bounds for which agency theory works.⁶¹⁹ This would mean developing a framework that would not be applied too generally and risk encroaching into areas where different theories might be better suited to explain the phenomena.

⁶¹⁶Preece, D. C., Mullineaux, D. J., Filbeck, G., & Dennis, S. A. (2004). Agency theory and the house bank affair. *Review of Financial Economics*, 13(3), 259-267. doi:10.1016/j.rfe.2003.09.008

⁶¹⁷Wright, P., & Mukherji, A. (1999). Inside the firm: Socioeconomic versus agency perspectives on firm competitiveness. *The Journal of Socio-Economics*, 28(3), 295-307

⁶¹⁸Jensen, C., & Meckling, H. (1976). Theory of the firm: Managerial behaviour, agency costs and ownership structure. *Journal of Financial Economics*, 3, 305-360.

⁶¹⁹Eisenhardt, M. (1989). Agency theory: An assessment and review. *Academy of Management. The Academy of Management Review*, 14(1), 57-74.

4.5.3 Multi-theoretical Frameworks

One of the main challenges in the design of a multidisciplinary theoretical framework is to ensure that, despite their differences, the various theories are linked within a cohesive theoretical context ⁶²⁰ as opposed to just being linked through empirical design. In this research design a multi-theoretical framework has been developed that has used overlapping paradigms that are loosely connected with the perspectives and applications of agency theory. This framework has applied the agent-principle element to various partnerships within a money laundering relationship.

4.5.4 Multi-theoretical Approach

In order to fully understand the implications of the agency dilemma experienced by banks two other theories were also considered in the research and remain on the outskirts of the research framework. The first of these was game theory, which provides some understanding of the implications of changing one aspect of the dual agency relationship. This was seen as important when considering any changes to the regulatory framework, since research has been done to consider the impact on criminal behaviour in response to regulation change.

⁶²⁰ Modell (2009)

The second theory that was considered was systems theory, especially the work of Demetis & Angell (2005, 2007),⁶²¹ which considered AML as a system and acknowledged the global aspect of criminality. This would provide some insight into the influences on criminal motivation and thinking at an international level and was broader than the banking context.

4.6 Research context

The research questions are supported by a contextual framework that includes the overall research philosophy, the background context and the underlying ontological and epistemological assumptions of the project.

The empirical research context that was being explored was to understand under what kind of scenarios the TBML client might present to the bank. The current gaps that were highlighted from the literature review section showed that one of the challenges in establishing a contextual background would be the limited examples and case studies of TBML within banking. Alongside this there was a research assumption that there would also be a limited understanding of TBML amongst banking staff since there were no real training or research material available for them to have studied. There was also often only limited academic writing

⁶²¹ Demetis, D. S., & Angell, I. O. (2007). The risk-based approach to AML: Representation, paradox, and the 3rd directive. *J of Money Laundering Control*, 10(4), 412-428. doi:10.1108/1368520071083090

specifically of TBML, and it covered several discipline areas including criminology, banking & auditing and IT data management.

4.6.1 Research Paradigms

The first stage in developing a framework was to establish a paradigm that the research could operate within. This was particularly important considering the mixed method approach ⁶²² that was being considered. A paradigm is a belief framework that guides the work and ensures that the appropriate methods are selected for the nature of the research being conducted.

*“Within the science studies, the consensual set of beliefs and practices that guide a field is typically referred to as a ‘paradigm’.”*⁶²³

One of the challenges in defining a paradigm is that there are a number of different definitions used in research. Morgan identifies four different uses for the word, which include - worldview approaches; epistemological approaches; model examples and shared beliefs in research. All four types offer different perspectives that can be applied to a research framework. One of the most common types currently being

⁶²² Mengshoel. (2012). Mixed methods research - so far easier said than done? *Manual Therapy*, 17, 373-375

⁶²³ Morgan, D.L., 2007. Paradigms lost and pragmatism regained: methodological implications of combining qualitative and quantitative methods. *Journal of Mixed Methods Research* 1 (1) (p49)

applied is the epistemological stance, whereby the epistemological, ontological and methodological approaches share a broad philosophical position.⁶²⁴

This latter type of paradigm approach has been utilised in this research design, whereby the research used the definition of paradigm as a 'world view on events'⁶²⁵ but also applied an epistemological approach to the research. This is similar to a definition of paradigm that Schwandt used⁶²⁶ and which Morgan describes as mixing two of the main four versions of paradigms. The world view of AML compliance was gained through the industry reports and case studies, whilst the ontological understanding and theoretical framework were developed from the academic literature. This information provided a set of research assumptions that according to other social scientists⁶²⁷ is typical of many social science research designs.

The traditional research paradigms of positivism and interpretivism were both initially considered as part of this research design. However, it was felt that neither model offered exactly what was needed to support this particular research philosophy.

⁶²⁴ Morgan, D.L., 2007. Paradigms lost and pragmatism regained: methodological implications of combining qualitative and quantitative methods. *Journal of Mixed Methods Research* 1 (1) (p49)

⁶²⁵ Glaser, B. G. (2003). Naturalist inquiry and grounded theory. *Forum Qualitative Sozialforschung / Forum: Qualitative Social Research*, 5(1), 1-14

⁶²⁶ Schwandt, T. (1989). Solutions to the paradigm controversy: Coping with uncertainty. *Journal of Contemporary Ethnography*, 17(4), 379-407.

⁶²⁷ Creswell. (2003). *Research design: Qualitative, quantitative, and mixed methods approaches* (2nd ed). Thousand Oaks, CA: Sage.

4.6.1.1 Traditional Paradigms

Traditional research in the social sciences has tended to operate from within one of two main paradigms either of constructivism, or logical empiricism. Both types have their own clear ontological and epistemological positions,⁶²⁸ and from each of these positions a group of clear research methods are used that support their respective positions. The broader paradigms of constructivism and logical empiricism are often seen as being in competition with each other⁶²⁹ and are linked to the research approaches of interpretivism or positivism respectively. Interpretivism tends to be associated with inductive and qualitative based research strategies whereas the logical positivism is aligned with the deductive and quantitative research approaches.⁶³⁰

However, modern research has recognised the need to develop research strategies that are more focused on answering the specific research question, rather than being entrenched into certain research styles.⁶³¹ One way in which this can be achieved is through combining research methods into a different type of paradigm framework, whereby the purpose for combining these techniques is to provide both greater

⁶²⁸ Maxwell, J.A (1996) *Qualitative Research Design: An interactive approach* London: Sage Publications

⁶²⁹ Morgan (2007)

⁶³⁰ Pluye, P., Gagnon, M. P., Griffiths, F., & Johnson-Lafleur, J. (2009). A scoring system for appraising mixed methods research, and concomitantly appraising qualitative, quantitative and mixed methods primary studies in mixed studies reviews. *International Journal of Nursing Studies*, 46(4), 529-46. doi:10.1016/j.ijnurstu.2009.01.00

⁶³¹ Dawson, T. L., Fischer, K. W., & Stein, Z. (2006). Reconsidering qualitative and quantitative research approaches: A cognitive developmental perspective. *New Ideas in Psychology*, 24(3), 229-239. doi:10.1016/j.newideapsych.2006.10.001

breadth and insight into the issue being researched.⁶³² This is known as the research philosophy.

4.6.2 Level 1 - Research Philosophy for TBML Project

4.6.2.1 Research Philosophy

The research philosophy plays a pivotal role in the development of the research framework, because it provides a transparent means of identifying the assumptions and beliefs of the researcher and the research process in relation to the study being undertaken.

The research project was looking for a philosophy that would enable empirical evidence to be strongly embedded into a theoretical framework. The challenge the research project was facing was firstly to seek a philosophical approach that would match the empirical nature of the TBML research questions, which were specific to the financial services and banking sectors. Secondly, the philosophy had to acknowledge the wide variety of opinions that participants would be bringing to the research through their own sense of reality and experiences across the globe. It was this individual perspective that was very important to capture in order to develop a true understanding of the global TBML situation. Normally research philosophies work from one of two frameworks; positivism or interpretivism.

⁶³² Pluye et al (2009)

4.6.2.2 Positivism

Positivism is largely associated with scientific research where there is an emphasis on objective facts and a value free interpretation of the results.⁶³³ It is an approach largely suited to laboratory controlled environments where independent influences can be managed by the researcher in a structured format.⁶³⁴ Although there have been acknowledgements that value free science is a fallacy⁶³⁵ the methods used in this approach and for the data analysis still tend to be predominantly quantitative.

However, the nature of this research project meant that highly controlled environments were not relevant, since information needed to be collected from real life empirical situations, across a number of institutions and from different parts of the globe. Secondly, the various controls associated with the nature of this work are either largely unknown or too large to be controlled in any research design, therefore data had to be collected within an unpredictable but naturalistic environment.

4.6.2.3 Interpretivism

⁶³³ Robson, C (2002) *Real World Research* (2nd ed.) Oxford: Blackwell Publishing

⁶³⁴ Maxwell, J,A (1996) *Qualitative Research Design: An interactive approach* London: Sage Publications

⁶³⁵ Smith, M. L. (2006). Overcoming theory-practice inconsistencies: Critical realism and information systems research. *Information and Organization*, 16(3), 191-211. doi:10.1016/j.infoandorg.2005.10.003

Interpretivism or as it is sometimes known constructivism, was developed partly in response to reject the overly scientific and quantitative focus of positivism, especially within social science settings.⁶³⁶ Instead interpretivism supported the view that every choice in research had a consequence. It was suggested that the researcher along with their beliefs and their knowledge, are also part of the research decision making processes.⁶³⁷ The research reality is thus created by the participants and researcher and incorporates all their beliefs and views of the world, as opposed to proving a truth from the analysis of data such as in quantitative designs.⁶³⁸ Most research in this category tends to be inductive and seeks to provide a descriptive narrative to explain underlying laws.⁶³⁹ The methods associated with interpretivism tend to produce more qualitative data.

The nature of interpretivist research, which seeks to look for underlying explanations rather than just causal links has caused several researchers to consider its use within social science research.⁶⁴⁰ Some of the subjects using this approach include areas similar to AML regulation, such as information systems within organisations.

⁶³⁶ Robson (2002)

⁶³⁷ Angen, M.J. (2000). Evaluating interpretive inquiry: Reviewing the validity debate and opening the dialogue. *Qualitative Health Research*. 10(3) pp. 378-395.

⁶³⁸ Robson (2002)

⁶³⁹ Smith, M. L. (2006). Overcoming theory-practice inconsistencies: Critical realism and information systems research. *Information and Organization*, 16(3), 191-211. doi:10.1016/j.infoandorg.2005.10.003

⁶⁴⁰ Smith, M. L. (2006). Overcoming theory-practice inconsistencies: Critical realism and information systems research. *Information and Organization*, 16(3), 191-211. doi:10.1016/j.infoandorg.2005.10.003

*“led many researchers to argue for an interpretivistic approach to the study of information systems.”*⁶⁴¹

One of the difficulties with interpretivist methods is that they are often small scale focusing on case studies and a smaller participant pool.⁶⁴² In this research project a broad cross section of respondents was needed in order to capture a global snapshot of TBML responses across the banking sector. Similarly using individual case studies was not an option since the amount of data within one bank would potentially be too small for analysis purposes. The arguments raised by proponents of other research paradigms were also applicable here in this study such as the view that interpretivism was felt to be too subjective in its understandings and socio-political interpretations, whereas positivism was seen as being completely value neutral and having only a scientific focus.⁶⁴³

However, this research design needed to consider beyond the traditional restrictive boundaries of interpretivism and positivism and seek something that was more compatible with the project, a point that Yanchar (2006)⁶⁴⁴ also agreed was important.

“...a growing recognition that the traditional qualitative-quantitative debate has outlived whatever benefits it

⁶⁴¹ Smith (2006) p196

⁶⁴² Robson, C (2002) Real World Research (2nd ed.) Oxford: Blackwell Publishing

⁶⁴³ Smith, M. L. (2006).

⁶⁴⁴ Yanchar, S. C. (2006). Beyond the qualitative–quantitative divide: How to proceed? New Ideas in Psychology, 24(3), 275-281. doi:10.1016/j.newideapsych.2006.10.005

historically provided, that methods must be matched with the research question or problem at hand, and that these matches of question and methods must be accompanied by critical reflection and sound rationale.”⁶⁴⁵

In response the researcher considered a third type of research philosophy that of pragmatism, which includes elements of both interpretivism and positivism.⁶⁴⁶ This meant that in effect both types of philosophy, interpretivism and positivism were considered and although interpretivism was the stronger candidate for the research design, both philosophies were deemed to be too restrictive for the nature of the research being undertaken. This meant that the more pragmatic approach would enable the TBML topic itself to provide the links between any differing philosophies and methods.

This research project had acknowledged from the beginning that differences in reality will exist amongst the project participants, simply because a number of different disciplines are involved that are operating from different contextual and epistemological positions, so therefore there will inevitably be a strong element of diversity. A pragmatism framework will facilitate this by being more flexible and open to using different methods of information gathering, in order to seek clarification and

⁶⁴⁵ Yanchar (2006) p275

⁶⁴⁶ Morgan, D.L., 2007. Paradigms lost and pragmatism regained: methodological implications of combining qualitative and quantitative methods. *Journal of Mixed Methods Research* 1 (1), 48-76.

understanding i.e. developing a realistic contextual framework from the data as it emerges.

4.6.2.4 Critical realism

There are some similarities between the research approaches of pragmatism and critical realism.⁶⁴⁷ This section outlines the basic concepts of critical realism in order to highlight how elements of this approach could be used alongside a pragmatism framework.

Critical realism acknowledges that empirical studies often need to be supported by other methods. However, unlike pragmatism, which is open to using other empirical based techniques to achieve this. Critical realism supposes that theoretical frameworks should be used to bridge the gap between the quantitative and verifiable data and the qualitative and more subjective data. Modell (2009) describes this approach as using three elements.

“critical realism is based on a tripartite, ‘stratified’ ontology divided into the domains of real objects and mechanisms, actual events and empirical experiences.”⁶⁴⁸

To apply that model to this research project then the elements of TBML/AML regulation would be seen as a real object or mechanism,

⁶⁴⁷ Modell (2009)

⁶⁴⁸ Modell (2009, p212)

whereas the actual money laundering and also risk assessment would be classified as events. The third element is the empirical experiences of both staff and clients, which would be described in a critical realism framework but separated from the other slightly more objective elements. Historically, critical realism emerged, in part, as a way of explaining inconsistencies that were noted between theory and practice in positivist research. They offered a third way by putting forward another interpretation of scientific research.⁶⁴⁹

The main difference between critical realism⁶⁵⁰ and pragmatism Modell⁶⁵¹ (2009) suggests, is that critical realism is more aware of the implications of abandoning a concept of reality that is governed by determined scientific rules. In other words, critical realism is more aligned to positivist thinking and is still heavily influenced by the need to explain scientific events in indisputable terms.⁶⁵² Following this line of thinking and as a logical follow on, pragmatism is not as restricted by functionalist perspectives and is more open to interpretivist views than critical realism. The latter point is an advantage in this research because the research project is also open to following an interpretivist perspective, unlike the

⁶⁴⁹ Smith, M. L. (2006). Overcoming theory-practice inconsistencies: Critical realism and information systems research. *Information and Organization*, 16(3), 191-211. doi:10.1016/j.infoandorg.2005.10.003

⁶⁵⁰ Smith, M. L. (2006). Overcoming theory-practice inconsistencies: Critical realism and information systems research. *Information and Organization*, 16(3), 191-211. doi:10.1016/j.infoandorg.2005.10.003

⁶⁵¹ Modell, S. (2009). In defence of triangulation: A critical realist approach to mixed methods research in management accounting. *Management Accounting Research*, 20(3), 208-221. doi:10.1016/j.mar.2009.04.001

⁶⁵² Pluye, P., Gagnon, M. P., Griffiths, F., & Johnson-Lafleur, J. (2009). A scoring system for appraising mixed methods research, and concomitantly appraising qualitative, quantitative and mixed methods primary studies in mixed studies reviews. *International Journal of Nursing Studies*, 46(4), 529-46. doi:10.1016/j.ijnurstu.2009.01.009

general work and interest of Modell who tended to prefer functionalist approaches.

The pragmatist approach was therefore considered the more flexible approach, that would aim to be objective as far as possible whilst at the same time mindful that many of the pieces of research literature to be reviewed, as well as the primary data would nearly all be from very subjective sources.

The philosophy underpinning this research project can be summarised as, the belief that the subject matter of TBML is of great importance to the banking sector both now and especially moving forwards into the future. However, by the nature of its complexity TBML is a challenging topic to discover and undertake risk assessment for. Therefore, given the complex nature of the topic and the range of inter-agency groups involved in the assessment of risk, and the subsequent reporting processes, this has led the research to consider an approach that is exploratory in nature.

4.6.3 Level 2 - Research Approach

The previous section outlined the philosophical stance chosen by the project and the differences that exist between pragmatism, and interpretivism or positivism. Since the research was operating within a real empirical context of money laundering and wanted to speak to current

professionals working in this field, the research sought to use an exploratory framework. This would enable opinions to be sought from individuals working in the area and in the analysis of such information it would provide the option to develop potential solutions to any problems that might be identified. These problems were not known at the start of the research and would emerge from within the data during the analysis phase.

4.6.3.1 Delphi Analysis

Delphi analysis is a research technique that was first developed in the 1940s at the RAND Corporation in California. The researchers there had determined that group expertise was more accurate than individual expertise and were exploring the possibility of developing a scientific application of this.⁶⁵³ Originally Delphi analysis was used only in military intelligence and research and therefore published discussion about its use was not revealed until the 1950s.

In research one of the uses of the Delphi method is to gather information and reach consensus from a range of expert opinions and as in this research project, across a range of disciplines.⁶⁵⁴ The traditional Delphi Analysis approach involves using repeated questionnaires designed to encourage participants to revise their initial thoughts on topics

⁶⁵³ Landeta, J. (2006). Current validity of the delphi method in social sciences. *Technological Forecasting and Social Change*, 73(5), 467-482. doi:10.1016/j.techfore.2005.09.002

⁶⁵⁴ Hsu, C. -C., & Sandford, B. A. (2007). The delphi technique: Making sense of consensus. *Practical Assessment, Research & Evaluation*, 12(10)

and merge opinions into a consensus. The aim is that consensus amongst experts is reached through a repeated process of reviewing and refining opinions based on new knowledge and opinions and it is through this process that validity is introduced rather than through using statistical results.⁶⁵⁵

However, other research studies have used adapted versions of the methodology especially where the focus is broader across many diverse opinions.⁶⁵⁶ In Landeta's research the Delphi model was evaluated using three different situations in order to ascertain the degree of flexibility and applicability of this research tool in different social science settings. Landeta⁶⁵⁷ discovered that it had a wide range of flexibility and could be applied across a variety of social science research settings effectively. Other researchers have also supported the view that the Delphi approach has a degree of flexibility in its design and is amenable to using follow up interviews in addition to any questions or surveys used.⁶⁵⁸

According to Cole, Donohoe & Stelleso (2013) the use of expert opinion is a positive way to establish a baseline position upon which to develop the rest of the research data collection process *"...the Delphi is, therefore, the best for providing baseline information (perceptions, opinions, and insights) into a given topic where consensus can serve as a*

⁶⁵⁵ Cole, Z. D., Donohoe, H. M., & Stelleson, M. L. (2013). Internet-Based delphi research: Case based discussion. *Environmental Management*, 51, 511-523. doi:10.1007/s00267-012-0005

⁶⁵⁶ Landeta (2006)

⁶⁵⁷ Landeta (2006)

⁶⁵⁸ Okoli, C., & Pawlowski, S. D. (2004). The delphi method as a research tool: An example, design considerations and applications. *Information & Management*, 42(1), 15-29

*springboard to additional conversation and development*⁶⁵⁹ This last point is of particular interest to this research and was used as the basis for developing the data collection tools as well as determining some of the areas of literature to be considered within the review.

4.6.3.2 E-Delphi

This research project has opted for an adaptation of the traditional Delphi approach known as an e-Delphi approach.⁶⁶⁰ This approach was adopted since the focus of the research was on gathering opinions and thoughts from across the globe and from a variety of sectors involved in TBML investigation. This was similar to the challenges faced in the research analysed by Landeta⁶⁶¹ that had also used the Delphi technique. It would also enable a greater level of creative thinking in developing a solution by hearing different global voices and perspectives, which is one of the unique advantages of Delphi research techniques.⁶⁶²

“The aim of this technique was to avoid the problems resulting from the multi-campus location of experts, their frequent travelling and stays abroad, their different

⁶⁵⁹ Cole, Z. D., Donohoe, H. M., & Stelleson, M. L. (2013). Internet-Based delphi research: Case based discussion. *Environmental Management*, 51, 511-523. doi:10.1007/s00267-012-0005 p513

⁶⁶⁰ Cole, Z. D., Donohoe, H. M., & Stelleson, M. L. (2013). Internet-Based delphi research: Case based discussion. *Environmental Management*, 51, 511-523. doi:10.1007/s00267-012-0005

⁶⁶¹ Landeta, J. (2006). Current validity of the delphi method in social sciences. *Technological Forecasting and Social Change*, 73(5), 467-482. doi:10.1016/j.techfore.2005.09.002

⁶⁶² Nowack, M., Endrikat, J., & Guenther, E. (2011). Review of delphi-based scenario studies: Quality and design considerations. *Technological Forecasting and Social Change*, 78(9), 1603-1615. doi:10.1016/j.techfore.2011.03.006

*timetables, the differences between status and personality, the influence of their group or class interests and possible prejudices or concerns of a political nature.*⁶⁶³

It was therefore not feasible to consider bringing the Delphi group members together and instead the use of the internet via electronic surveys, telephone interviews and email contact was used instead. However, despite the many advantages of using such a technique the usual limitations, including the time taken to communicate and circulate information to all the members of the panel still applied, although with the internet this was less cumbersome than using paper versions which is often used in the more traditional Delphi research designs.⁶⁶⁴

The aim of the Delphi approach in this study was to act as an aid to decision-making in the development of a risk assessment approach within the banking context, and it was not expected that there would ever be complete consensus on the topic. The main challenge instead for the research project was to determine how the expertise would be identified and which representatives would be included in the Delphi approach, as well as establishing a clear trail of trustworthiness within the process.⁶⁶⁵

4.6.3.3 Expert Panels

⁶⁶³ Landeta, J. (2006)p476

⁶⁶⁴ Cole et al., (2013)

⁶⁶⁵ Hasson, F., & Keeney, S. (2011). Enhancing rigour in the delphi technique research. *Technological Forecasting and Social Change*, 78(9), 1695-1704. doi:10.1016/j.techfore.2011.04.00

One of the problems of Delphi approaches is the reliance on the expertise of the group selected. Selection is therefore a crucial component of Delphi analysis, especially to choose a good or acceptable group, which fulfils the research standards.⁶⁶⁶ One recommendation that was considered from literature on this topic, was to use different panels of experts for the different areas of work.⁶⁶⁷ However, this approach could have been quite cumbersome for this project given the broad scope of interagency involvement in TBML investigation. Instead of using this approach directly it was honed down on a practical level, to use two panels of experts; one for those working in the financial services and one panel of those experts who had a role in investigative TBML work.

Initially in the research design four panels had been suggested to potential experts, which were later merged into the two final areas. Originally the financial services panel had been split into internal audit and AML officers /other, whilst the intelligence panel had been subdivided into law enforcement and financial intelligence units. However, a revised restructuring was undertaken to simplify things and because the expert panel were asked to self-select which group they felt their expertise was best suited. The feedback the researcher felt was coming from the experts, was that four panels was seen as too complex, with insufficient differences between the main elements of the panels. The downside was that even with the two different panels some experts still did not feel that

⁶⁶⁶ Linstone, H. A., & Turoff, T. (2002). *The delphi method--techniques and applications* (2nd ed.). London: Addison-Wesley Publishing Company

⁶⁶⁷ Landeta, J. (2006). Current validity of the delphi method in social sciences. *Technological Forecasting and Social Change*, 73(5), 467-482. doi:10.1016/j.techfore.2005.09.002

this covered their own area of work e.g. training consultants or financial advice consultants who worked across both sectors. As a compromise the research offered anyone participating in the surveys to choose where they felt the best fit was for them and the experts were also given the option to become members of both panels in order to try and maximise the value and relevance of their input.

One advantage of using the E-Delphi approach, which was supported in the research design, was that the experts did not have to physically meet either each other, or the researcher and therefore confidentiality was assured.⁶⁶⁸ For most members of the group this aspect was felt to be vitally important for their participation. The experts that agreed to participate were sourced from across the world to try and capture a global AML/TBML perspective. The limited resources and numbers of experts in this area would potentially have meant that by focusing on one area of the global trade market, the research would be unlikely to elicit enough contacts for the project. The global nature of TBML also meant that shipping and trade incidents of TBML were likely to involve countries across different jurisdictions and with different approaches to AML detection.

In addition, there were problems in isolating cases on geographical boundaries since this method could have proved quite difficult and would have meant relying on and being restricted by, the data available to the

⁶⁶⁸ Okoli, C., & Pawlowski, S. D. (2004). The delphi method as a research tool: An example, design considerations and applications. *Information & Management*, 42(1), 15-29

limited resources of the FIUs in that area, and the banks of those countries. Instead the research decided to throw the net wide open and accept and contact experts and cases from across the globe, in the knowledge that this pool was not very big anyway and there would not be any great chance of being inundated with too many case studies or people.

4.6.3.4 Expert Panel

The research strategy consisted of collecting and analysing data from a number of different primary sources. The overall purpose for the research data was to try and identify an appropriate risk framework suitable for TBML risk assessment within the banking context. In order to achieve this and to develop the data collection approach to be appropriate for the experts involved, the research process was designed to maximise consensus agreement for each of the main stages of the research process, using the two different panels of experts. This included establishing through the experts how many categories of TBML expertise there were. There were originally four groups, but it was felt there was too much overlap between the group headings and experts could not decide which group fitted them best. This was then narrowed to two which separated out financial investigation and intelligence from banking and AML detection. All the experts agreed to participate in an online survey and expressed interest in participating in a follow on interview or responding to email clarifications.

The two panels that were developed consisted of experts. For group one this was experts within the field of Financial Intelligence linked to both the banking sector and financial auditing sectors. This also covered people working within the regulatory services and intelligence staff from law enforcement. The second group of experts were from the Financial Services sector and consisted of experts working directly on AML / TBML issues, including internal audit and governance.

The data collection phase of the research was divided into two main stages and these are outlined below;

Stage one - Identify potential expert members and use their expertise to finalise research proposal.

1. A literature review was completed that involved reading current empirical and theoretical literature on the topic of TBML, and noting key authors with their contact details and notes of other papers written or work undertaken in the sector.
2. The expert panels were first of all invited to review the research proposal and to give suggestions for amendments, and asked if they would be interested in being involved in the project. A cross section of experts was targeted from across the globe and from within academic writing, auditing research and intelligence gathering for typology reports.

3. At this stage some of the experts stated that they did not feel they had the expertise and suggested other colleagues so there was an element of changing between experts until the appropriate people were in situ.

Stage Two - Design online survey and follow on semi-structured interviews with those experts who wanted verbal discussion as well as / instead of email contact.

4. Once a detailed proposal had been developed with a theoretical framework, clear methodology and simple literature review, the panel were invited to complete an online questionnaire on their area(s) of expertise, i.e. within financial intelligence and/or financial services including banking and auditing.
5. The expert panel were also used to develop the online questionnaires that eventually were used in the research data. This was done by sending out pilot questionnaires using the four initial sub categories (Audit, Banking, Law Enforcement & Financial Intelligence). These were distributed to the panel and feedback was received as to whether other areas of questioning needed to be included.
6. The final drafts of the questionnaires were then uploaded to 'SmartSurvey' and members of the panel who had not responded to the initial questionnaire were asked to

complete the online version instead. In the design of the on-line version and in response to some of the feedback from the panel, the researcher adapted the format to only use the two broader areas of Financial Services and Financial Intelligence, since it was felt that there was significant overlap in some of the other areas.

7.

4.6.4 Level 3 - Research Strategy

This section explores the research strategy ⁶⁶⁹ employed by the project and the rationale for choosing the methods used. The research strategy is still underpinned by the overall purpose of the research, which was to identify the influences that impact on a TBML transaction and to develop a deeper understanding of how these relate to the banking context. This was to be achieved by using a pragmatist philosophy, which was seeking to develop a risk assessment model that was transferable across the banking sector and would therefore use an abductive approach to gather and interpret the data.

The next stage for the framework was to develop a strategy that would ensure that all the data and information could be collected and analysed in such a way, as to be suitable for understanding the banking risks that are linked to TBML activity. The philosophy underpinning the

⁶⁶⁹ Saunders, M., Lewis, P., & Thornhill, A. (2007). *Research Methods for Business Students*, (6th ed.) London: Pearson.

strategy was to use a pragmatic but exploratory process that would maximise the potential for uncovering the full range of data on the subject. Finally, under the guidance of the pragmatism framework and the research strategy, the next stage was to consider the most appropriate methods of data collection, without feeling any undue constraint from the paradigms informing those methods.⁶⁷⁰

4.6.4.1 Challenges for the research strategy to address

The research strategy had to work around or address a number of challenges that had been identified in the course of developing the framework. These were listed under three main headings of; empirical challenges relating specifically to collecting data within the banking and related sectors on the topic of TBML; the multidisciplinary nature of the respondents with differing levels of expertise on the subject matter and finally, the last challenge was to integrate the theoretical framework into the research strategy so that theory and practical findings interlinked throughout the research project.⁶⁷¹ The next section looks at each of these areas and discusses them in more detail.

⁶⁷⁰ Morgan, D.L., 2007. Paradigms lost and pragmatism regained: methodological implications of combining qualitative and quantitative methods. *Journal of Mixed Methods Research* 1 (1), 48-76.

⁶⁷¹ Östlund, U., Kidd, L., Wengström, Y., & Rowa-Dewar, N. (2011). Combining qualitative and quantitative research within mixed method research designs: A methodological review. *International Journal of Nursing Studies*, 48(3), 369-83. doi:10.1016/j.ijnurstu.2010.10.00

4.6.4.2 Empirical Challenges

In order to devise an appropriate strategy that would answer the research questions effectively, a number of difficulties had to be addressed at an empirical level, which had already been highlighted in the literature review section.

1. Firstly, TBML was acknowledged from a number of sources as being a difficult issue to address.⁶⁷² This meant that there was not a straightforward solution expected from the research findings. On the other hand, these 'difficulties' also had to be broken down even further in order to develop and describe an accurate contextual situation.
2. Another point to be considered was that TBML did not affect the banking sector in isolation, but was also linked into a number of other agencies and disciplines, especially once suspicious activity was detected. Therefore, the research needed to gain some of the opinions and insights from these other sectors as well, if a full picture of TBML within banking was to be developed.
3. Finally, in order to develop an accurate risk assessment framework for TBML there needed to be some understanding of prediction, i.e. knowing the expected

⁶⁷² FATF. (2008). Trade based money laundering. France. Financial Action Task Force

consequences to the proposed risk assessment process if any of the other parameters changed. This meant that the data had to be located within a theoretical framework, one that dealt with consequences in order to understand the nature of the predicted behaviour and responses from TBML clients, as well as collecting information from an empirical framework.

As part of the pragmatic approach, the research aimed to utilise existing larger and international pieces of work and from these pieces to discover and explore the issues that seem to be common and prevalent within the sector. These issues would be connected to TBML, and also the wider issues of financial crime section within the global banking sector. It was hoped that this would help to overcome some of the limitations in accessing relevant respondents, as well as any potential limited access to different agencies working on the issue of TBML. Rather than these issues being considered as a barrier to data collection, other data collection methods were built into the design of the research in order to overcome any anticipated difficulties. All of the above mentioned concerns were then included in the development of a data analysis framework, which could highlight areas of potential weakness due to lack of geographic representation, biases in representation from certain sectors or limited experience of TBML for some of the participants.

4.6.4.3 Multi-disciplinary

The second issue to be addressed was the multi-disciplinary approach to working with TBML. A number of agencies are involved in the reporting and detection of suspected TBML activity, these include, financial intelligence units, law enforcement, financial regulators, as well as other banking and financial services. The challenge of analysing a diverse range of perspectives was incorporated into the research strategy by using a Delphic analysis approach⁶⁷³ throughout the data collection and analysis periods. This ensured that views and opinions were collected from across all the relevant sectors involved in TBML transactions and reporting. This included gathering opinions from respondents in the centralised financial intelligence units and using material within published articles from law enforcement, and analysing secondary data in the form of industry reports from auditing companies. The literature reviews also considered papers written from all these perspectives to ensure that the academic input did not carry unnecessary bias through any misrepresentation of the sectors.

4.6.4.4 Theoretical framework

The final element was the theoretical framework that had to be integrated into the data collection and analysis process as well. This was

⁶⁷³ Okoli, C., & Pawlowski, S. D. (2004). The delphi method as a research tool: An example, design considerations and applications. *Information & Management*, 42(1), 15-29

achieved through using a systemic literature review ⁶⁷⁴ that focused specifically on AML and TBML issues, including both empirical and theoretical perspectives from across a number of disciplines and countries. In addition to these approaches the data collection methods that were used, were from both the quantitative and qualitative approaches and were used in conjunction with each other ⁶⁷⁵ in order to expand the breadth and depth of understanding on the TBML topic. An established theoretical framework had been developed for the project, which has been described. However, there were other forms of theoretical strategy that could have been used in the research, the most considered of these was a grounded theory strategy.⁶⁷⁶

4.6.4.5 Grounded Strategy

Grounded theory starts from an open position with no established theoretical context, it then uses an inductive approach whereby the theory is developed after the initial observations have been gathered.⁶⁷⁷ This was seen as potentially relevant to this design because it would have ensured that the final theoretical framework was directed by the research findings, rather than theories being imposed on the initial research design.

⁶⁷⁴ Rhoades, E. A. (2011). Literature Reviews. *The Volta Review*, 111(1), 61+. Retrieved from <http://www.questia.com>

⁶⁷⁵ Harrison, R. L. (2013). Using mixed methods designs in the journal of business research, 1990–2010. *Journal of Business Research*, 66(11), 2153–2162. doi:10.1016/j.jbusres.2012.01.00

⁶⁷⁶ Glaser, B. G. & Strauss, A. L. (1967). *The discovery of grounded theory: Strategies for qualitative research*. Chicago, Ill: Aldine

⁶⁷⁷ Robson, C (2002) *Real World Research* (2nd ed.) Oxford: Blackwell Publishing

However, given the complex nature of the subject matter it was felt by the researcher that some form of starting theoretical position was needed upon which to review the literature and to establish the contextual background to the project. The preliminary literature overview indicated that the agency dilemma was an important aspect in AML research,⁶⁷⁸ especially within the banking context. It was therefore decided to use this broad theoretical framework as a starting point, rather than allow a theoretical approach to emerge.

If necessary, this framework could be adapted and amended in accordance with the findings as it became clearer what the situation actually was. As with all research the chosen theoretical framework will add a subjective element to the overall interpretation⁶⁷⁹ but the researcher was mindful that this framework was open to change if needed.

Modell suggested that theory cannot stand alone and needs to be constantly integrated into the empirical findings and so the researcher tried to incorporate this viewpoint into the development of the overall research framework and in particular into the process of data analysis.

“Hence, the interpretations of researchers are highly dependent on their choice of theories and should not be

⁶⁷⁸ Pellegrina, L. D., & Masciandaro, D. (2008). The Risk Based Approach in the new European Anti-Money Laundering Legislation: A Law and Economics View. “Paolo Baffi” Centre Research Paper Series No. 2008-22, 1-24.

⁶⁷⁹ Modell, S. (2009). In defence of triangulation: A critical realist approach to mixed methods research in management accounting. *Management Accounting Research*, 20(3), 208-221. doi:10.1016/j.mar.2009.04.001

*conceived of as 'accurate' representations of an objective empirical reality 'out there'.*⁶⁸⁰

The research project is an exploratory piece of research that is seeking to establish banking related patterns of trade based money laundering and to collate this level of knowledge from across a number of organisations and disciplines. One of the challenges facing any researcher is the need to show methodological rigour⁶⁸¹ and this was considered especially challenging in this project given the newness and diverse discipline coverage that TBML spread across. It was deemed especially important that all the agencies and relevant sectors were represented in the data collection stage and that their views were given equal consideration. In order to accommodate the vast array of opinions a Delphi system of feedback and collaboration was used; using experts from across the major identified areas of law enforcement, criminology, finance, banking and audit.

4.6.5 Research Choices

The research was exploring a new topic within AML regulation which specifically focused on trade based money laundering and risk assessment, and thus needed to incorporate an element of exploratory research into the design. Existing and previous research that had been

⁶⁸⁰ Modell (2009, p211)

⁶⁸¹ Hasson, F., & Keeney, S. (2011). Enhancing rigour in the delphi technique research. *Technological Forecasting and Social Change*, 78(9), 1695-1704. doi:10.1016/j.techfore.2011.04.00

done on global AML issues had been more focused either on measuring the scale of global AML⁶⁸² and the implications in data software development.⁶⁸³ Or the research had been strictly country specific and focused on analysing trade data.⁶⁸⁴

Prior industry studies had looked at feedback from within the AML sector⁶⁸⁵ but had tended to be country specific and/or cutting across different types of financial services. This research wanted to work specifically within the global banking sector and look at risk assessment for TBML.

4.6.5.1 Exploratory Research

Exploratory research designs are often used to determine the nature of a problem that has not been previously researched.⁶⁸⁶ The purpose of exploratory research however, is to offer insights and information rather than develop specific conclusions.⁶⁸⁷ This approach might be construed as not entirely appropriate for this project, since

⁶⁸²Unger, B., & den Hertog, J. (2012). Water always finds its way: Identifying new forms of money laundering. *Crime Law Soc Change*, 57(3), 287-304. doi:10.1007/s10611-011-9352-z

⁶⁸³Ai, L., & Tang, J. (2011). Risk-based approach for designing enterprise-wide AML information system solution. *Journal of Financial Crime*, 18(3), 268-276.

⁶⁸⁴Yalta, A. Y., & Demir, I. (2010). The extent of trade mis-invoicing in turkey: Did post-1990 policies matter?

Zdanowicz, J. S. (2009). Trade-Based money laundering and terrorist financing. *Review of Law & Economics*, 5(2). doi:10.2202/1555-5879.1419

⁶⁸⁵GT Canada AML Survey Result. (2015). GT Canada AML survey result. (National Anti-Money Laundering survey report 2015)

⁶⁸⁶Brown R.B, (2006) *Doing Your Dissertation in Business and Management: The Reality of Research and Writing*, Sage Publications

⁶⁸⁷Saunders, M., Lewis, P., & Thornhill, A. (2007). *Research Methods for Business Students*, (6th ed.) London: Pearson.

recommendations and a proposed model of risk assessment were one of the ideal outcomes from the research. However, the risk assessment model and any recommendations would be a suggestion based on the findings of the data, rather than a definitive answer to a problem, so in that sense the exploratory research outcomes did match.

Exploratory research methods can be set within a real life situation rather than construed for research purposes such as in a laboratory setting. Research approaches such as naturalistic inquiry ⁶⁸⁸ have introduced mixed method techniques, which have combined qualitative and quantitative data collection tools and approaches. However, combining methods from across the different paradigms of functionalism and interpretative design can also pose additional barriers and difficulties,⁶⁸⁹ especially when it comes to analysing and interpreting data. One of the advantages of using an interpretative design can be to ensure that researcher and research design biases are minimized, by including methods of triangulation ⁶⁹⁰ and avoiding the analysis of data in isolation. This can be further supported, by having a clear theoretical framework that can be integrated closely with the empirical work.⁶⁹¹

⁶⁸⁸ Glaser, B. G. (2003). Naturalist inquiry and grounded theory. *Forum Qualitative Sozialforschung / Forum: Qualitative Social Research*, 5(1), 1-14

⁶⁸⁹ Modell, S. (2009). In defence of triangulation: A critical realist approach to mixed methods research in management accounting. *Management Accounting Research*, 20(3), 208-221. doi:10.1016/j.mar.2009.04.001

⁶⁹⁰ Modell, S. (2009). In defence of triangulation: A critical realist approach to mixed methods research in management accounting. *Management Accounting Research*, 20(3), 208-221. doi:10.1016/j.mar.2009.04.001

⁶⁹¹ Modell, S. (2005). Triangulation between case study and survey methods in management accounting research: An assessment of validity implications. *Management Accounting Research*, 16(2), 231-254. doi:10.1016/j.mar.2005.03.001

The main challenge therefore is to provide a research framework that is able to accommodate the different paradigms in both the data collection and the analysis stages of the design⁶⁹². Otherwise there is a danger of trying to squeeze one paradigm into the other and force qualitative data to produce quantitative results and/or vice-versa.

As with all research design and regardless of the approach adopted, all methods will reaffirm certain biases and will not offer completely impartial results.⁶⁹³

The research paradigm in this project was focused on a pragmatist approach albeit one carried out on an exploratory basis, in order to understand how risk assessment in TBML cases could operate. The same research questions could thus be applied to each of the different data collection methods and a common lens of 'TBML risk assessment' could be applied to all the data in the analysis section. This supports the view of many pragmatists who have defended combining methods⁶⁹⁴ from across

⁶⁹²Modell, S. (2010). Bridging the paradigm divide in management accounting research: The role of mixed methods approaches. *Management Accounting Research*, 21(2), 124-129. doi:10.1016/j.mar.2010.02.005

⁶⁹³Yanchar, S. C. (2006). Beyond the qualitative–quantitative divide: How to proceed? *New Ideas in Psychology*, 24(3), 275-281. doi:10.1016/j.newideapsych.2006.10.005

⁶⁹⁴Harrison, R. L. (2013). Using mixed methods designs in the journal of business research, 1990–2010. *Journal of Business Research*, 66(11), 2153-2162. doi:10.1016/j.jbusres.2012.01.006

Östlund, U., Kidd, L., Wengström, Y., & Rowa-Dewar, N. (2011). Combining qualitative and quantitative research within mixed method research designs: A methodological review. *International Journal of Nursing Studies*, 48(3), 369-83. doi:10.1016/j.ijnurstu.2010.10.005

different paradigms ⁶⁹⁵ by saying that, multiple of views of the same object is a positive thing even if the observations produce different results.⁶⁹⁶

This was especially true in this research case since the topic being researched is relatively new and was also an interdisciplinary topic, therefore agreed answers were unlikely to be attained given the context. One other factor that occurred alongside the research process but was not built into the design intentionally was the publication of a number of media investigations and articles covering emerging TBML cases. This provided a research opportunity since interviews and statements were made by senior banking officials to media journalists, these were sources the research project would not have been able to easily access but could use as secondary data to verify the contextual validity of the project. A research lens of 'TBML information on risk assessment' was applied to all the media reports covered and these were then included in the data section of the report.

Within the pragmatist framework an exploratory research approach ⁶⁹⁷ was selected as explained previously and since the nature of the research questions were largely exploratory and were not designed to test an already established hypothesis. This meant that a number of different research methods were considered in order to capture the full range of

⁶⁹⁵ Mengshoel. (2012). Mixed methods research - so far easier said than done? *Manual Therapy*, 17, 373-375

⁶⁹⁶ Modell, S. (2010). Bridging the paradigm divide in management accounting research: The role of mixed methods approaches. *Management Accounting Research*, 21(2), 124-129. doi:10.1016/j.mar.2010.02.005

⁶⁹⁷ Robson, C (2002) *Real World Research* (2nd ed.) Oxford: Blackwell Publishing

opinions and thinking on the topic. The methods used included two surveys, used alongside one to one email correspondence / informal interviews and an analysis of secondary empirical data.

4.6.5.2 Mixed Methods

The research project has already been identified as an exploratory piece of work that is seeking to establish a more detailed context in which TBML activity occurs and is detected within the main banking context. However, the topic of TBML is relatively new and therefore there are limited existing studies available from which to compare and contrast the most appropriate research methodology that could be used, especially from research which included a focus on empirical studies. Since this research project was seeking to gather data from a number of different empirical and theoretical sources then it seemed logical to consider using a mixed method approach to capture both the breadth and depth of what experts were saying within the industry.⁶⁹⁸ In using a mixed method (Qualitative and Quantitative) approach,⁶⁹⁹ a generic understanding of the pros and cons of mixed method approaches was important to consider.

The term mixed methods research (MMR) has been used by a number of researchers and is usually used to describe using both

⁶⁹⁸ Modell, S. (2010). Bridging the paradigm divide in management accounting research: The role of mixed methods approaches. *Management Accounting Research*, 21(2), 124-129. doi:10.1016/j.mar.2010.02.005

⁶⁹⁹ Harrison, R. L. (2013). Using mixed methods designs in the journal of business research, 1990–2010. *Journal of Business Research*, 66(11), 2153-2162. doi:10.1016/j.jbusres.2012.01.00

qualitative and quantitative research methods within a single research strategy or design.⁷⁰⁰ One school of thought for using mixed methods is that each approach has its own set of limitations and strengths, and by combining the two a stronger research design can be developed., so that the MMR design is often seen to produce more valid results.⁷⁰¹ This is often done through using quantitative data as the primary method for data collection and supporting this with further qualitative data, such as case studies to support or provide greater insight into the findings from a survey.⁷⁰²

Indeed, Yanchar has argued strongly in favour of rethinking the inclusion of quantitative approaches within interpretative research design. His argument suggests that numeric interpretation of data can be included or at least not explicitly excluded without some consideration, into investigative research. However, his strongest argument is perhaps that investigative research needs, by its very nature, to be flexible and open to using a multitude of methods and not be restricted by one approach over another.

“[Researchers need to] be open to sophisticated, innovative uses of multiple data sources, including text, interviews,

⁷⁰⁰ Mengsheel. (2012). Mixed methods research - so far easier said than done? *Manual Therapy*, 17, 373-375

⁷⁰¹ Mengsheel (2012)

⁷⁰² Modell, S. (2005). Triangulation between case study and survey methods in management accounting research: An assessment of validity implications. *Management Accounting Research*, 16(2), 231-254. doi:10.1016/j.mar.2005.03.001

*artefacts, observations, numbers, and experiences of all sorts to further their investigative aims.*⁷⁰³

However, critics of this approach⁷⁰⁴ have suggested that the model Yanchar supports also limits the type of quantitative approach that can be used, since they are insisting on an established or closely aligned relationship to the qualitative methods being used. Instead Dawson, Fisher & Stein support a different approach to merging the two traditions through the use of '*problem-focused methodological pluralism*.'⁷⁰⁵ They are strong advocates for a slightly more traditional qualitative approach for investigative research and are sceptical about the use, albeit adapted, of numeric data within investigative contextual research designs. Instead they suggest that the cognitive learning process of differentiation and integration can also be applied to ethnological developments, including re-examining how positivist and interpretivist traditions have differentiated between quantitative and qualitative methods. Now they claim in the post-positivist tradition the pendulum is swinging towards the integration of methods in research designs.

As a pragmatist design the merger of the two different paradigms was not as challenging an issue, since the focus was exploratory and seeking to provide more details on a problem through the provision of a

⁷⁰³ Yanchar, S. C. (2006). Beyond the qualitative–quantitative divide: How to proceed? *New Ideas in Psychology*, 24(3), 275-281. doi:10.1016/j.newideapsych.2006.10.005 p278

⁷⁰⁴ Dawson, T. L., Fischer, K. W., & Stein, Z. (2006). Reconsidering qualitative and quantitative research approaches: A cognitive developmental perspective. *New Ideas in Psychology*, 24(3), 229-239. doi:10.1016/j.newideapsych.2006.10.001

⁷⁰⁵ Dawson, Fisher & Stein (2006, p230)

stronger contextual situation. The decision to use quantitative data was as a mechanism to broaden the scope of the project rather than provide any statistical significance to the findings. The sample of qualitative data participants would be taken from across all the respondents who had already participated in the quantitative survey.

4.6.5.3 Primary Data

The final research design aimed to use an online questionnaire as the quantitative data alongside a series of online email and telephone interviews to enable the initial findings to be explored more fully. Both of these techniques would contribute towards the development of the emerging themes and models on risk assessment for TBML. All the primary data collection would be carried out between two panels of experts:

- a) One within the banking and auditing fields and
- b) The second one within the investigation and law enforcement fields.

4.6.5.4 Secondary Data

The primary data source was to be supported by a secondary data analysis of empirical documents, including surveys conducted amongst the global banking sector on financial crime, ML and CDD systems. In addition

to these a number of academic and theoretical papers written across the subject, on the various aspects of TBML would also be analysed. Although Mengshoel⁷⁰⁶ suggested that MMR should be done by 2 experts one in each field working together collaboratively, However, this was in reference to larger scale medical research whereas in a single research study such as this, both areas of data analysis could be done by one researcher.

4.6.5.5 Mixed Methods

Mengshoel also highlights the challenges of trying to merge data from different sources, especially when each data set tells a different story, the problem is, which data set is to be believed? Exploratory research and pragmatism is open to acknowledging that there is not one single truth to be uncovered, however unlike positivism answers are not seen as definitive proof, and similarly unlike interpretivism answers are not just seen as descriptions. Somewhere between the two ideologies, pragmatism states that the answers are all part of the truth, and that possibly there are other parts of the truth still missing. Westerman⁷⁰⁷ introduces the idea of a different paradigm being applied to the interpretation of data, when he suggests that in investigation and exploratory designed research, quantitative data can also be interpretive rather than always associated with the positivist paradigm.

⁷⁰⁶ Mengshoel. (2012). Mixed methods research - so far easier said than done? *Manual Therapy*, 17, 373-375

⁷⁰⁷ Westerman, M. A. (2006). What counts as "good" quantitative research and what can we say about when to use quantitative and/or qualitative methods? *New Ideas in Psychology*, 24(3), 263-274. doi:10.1016/j.newideapsych.2006.10.00

“It reflects the fact that investigators in the field at large think about quantitative methods in very different ways. On the one hand, I argued that quantitative research is interpretive (even though many proponents and opponents of these methods would disagree) and that this is a necessary and desirable feature of such research.”⁷⁰⁸

Although mixed methods research design aims to broaden the selection of sources and types of data it works with, it also still has to operate within a defined framework, one that will by its nature be inclusive or exclusive of certain methods and research approaches.⁷⁰⁹ Pluye, et al.⁷¹⁰ have pointed out that despite its acceptance in mainstream research design, there are relatively few studies that have actually examined the quality of mixed methods research. This is an issue that is also raised by Hassen and Keeney⁷¹¹ who highlight the challenges in using a Delphi approach, which is a mixed methods approach and is positioned across different paradigms of positivist and naturalistic approaches, there have been limited research studies on determining the reliability of using such as technique in all situations. However, this is not a reason not to use the

⁷⁰⁸ Westerman (2006, p264)

⁷⁰⁹ Yanchar, S. C. (2006). Beyond the qualitative–quantitative divide: How to proceed? *New Ideas in Psychology*, 24(3), 275-281. doi:10.1016/j.newideapsych.2006.10.005

⁷¹⁰ Pluye, P., Gagnon, M. P., Griffiths, F., & Johnson-Lafleur, J. (2009). A scoring system for appraising mixed methods research, and concomitantly appraising qualitative, quantitative and mixed methods primary studies in mixed studies reviews. *International Journal of Nursing Studies*, 46(4), 529-46. doi:10.1016/j.ijnurstu.2009.01.00

⁷¹¹ Hasson, F., & Keeney, S. (2011). Enhancing rigour in the delphi technique research. *Technological Forecasting and Social Change*, 78(9), 1695-1704. doi:10.1016/j.techfore.2011.04.00

design, merely a consideration that warrants additional caution and explanation.

“Aligning methods with problems insures that these integrations are not arbitrary, because the focus on addressing specific problems with a method leads to critical examination of its strengths and limitations for the specific problems.”⁷¹²

4.6.5.6 Triangulation with Mixed Methods Designs

Triangulation ⁷¹³ is the use of multiple data sources in order to substantiate results, or the use of different types of data in order to explain a concept in more depth. One of the main traditional uses of mixed method research designs has been to triangulate the different findings from both quantitative and qualitative data sources in order to determine a more accurate truth ⁷¹⁴ similar to a sailor using fixed points to locate the actual position of his ship. Triangulation in the social sciences can be traced as

⁷¹² Dawson, T. L., Fischer, K. W., & Stein, Z. (2006). Reconsidering qualitative and quantitative research approaches: A cognitive developmental perspective. *New Ideas in Psychology*, 24(3), 229-239. doi:10.1016/j.newideapsych.2006.10.001 p238

⁷¹³ Modell, S. (2005). Triangulation between case study and survey methods in management accounting research: An assessment of validity implications. *Management Accounting Research*, 16(2), 231-254. doi:10.1016/j.mar.2005.03.001

⁷¹⁴ Modell, S. (2009). In defence of triangulation: A critical realist approach to mixed methods research in management accounting. *Management Accounting Research*, 20(3), 208-221. doi:10.1016/j.mar.2009.04.001

far back as 1959 and the work of Campbell and Fiske ⁷¹⁵ who established that different concepts could be measured differently depending on the type of method chosen. However, triangulation has been open to criticism especially where different methods underpinned by different theoretical perspectives have been used together in the same research design.⁷¹⁶

Triangulation is a specific tool used to verify data, which is separate from using mixed methods to supply background information prior to undertaking a research study.⁷¹⁷ In a research project such as the one being undertaken in this study, it is acknowledged from the outset that different disciplines working on the issue of TBML will be operating from different realities, because it is such a wide subject matter. Therefore, it is to be expected that meanings and interpretation of data will be subjective and this bias needs to be built into the research design. Some of the concerns raised by critics of triangulation approaches over the use of cross over methods ⁷¹⁸ from both the traditional paradigms, have identified issues such as differing ontological and epistemological positions which they can claim cannot be merged together. However, with a pragmatic

⁷¹⁵ Modell, S. (2005). Triangulation between case study and survey methods in management accounting research: An assessment of validity implications. *Management Accounting Research*, 16(2), 231-254. doi:10.1016/j.mar.2005.03.001

⁷¹⁶ Blaikie, N.W.H., 1991. A critique of the use of triangulation in social research. *Quality and Quantity* 25, 115-136.

⁷¹⁷ Modell, S. (2009). In defence of triangulation: A critical realist approach to mixed methods research in management accounting. *Management Accounting Research*, 20(3), 208-221. doi:10.1016/j.mar.2009.04.001

⁷¹⁸ Blaikie, N.W.H., 1991. A critique of the use of triangulation in social research. *Quality and Quantity* 25, 115-136

approach they can be addressed through developing a specific pragmatist framework that identifies these potential issues from the outset.⁷¹⁹

*“If reality is seen as multidimensional and subjectively construed by researched individuals, the meanings attached to empirical phenomena will vary considerably.”*⁷²⁰

Some researchers such as Denzin⁷²¹ have distinguished between using *between-method* triangulation such as case studies and surveys and *within-method* triangulation such as different types of surveys. These it is argued, produce different outcomes in the way they are used to validate findings since within-method triangulation will still operate from a similar philosophy and approach, whereas between-method triangulation will incorporate differences in paradigms and philosophies.

Other researchers have highlighted the importance of incorporating the different strengths and weaknesses of each of the different methods involved, such as work undertaken by Campbell & Fiske⁷²² who devised a multitrait - multimethod matrix. This matrix was developed to illustrate the relative links between reliability and validity in measuring traits, and in so doing established the pattern that social constructs can rarely be accurately measured using one method over another, since all

⁷¹⁹ Modell (2009)

⁷²⁰ Modell (2009, p210)

⁷²¹ Denzin, N.K., 1978. *The Research Act. A Theoretical Introduction to Sociological Methods*, 2nd edition. McGraw-Hill, New York.

⁷²² Campbell, D. T., & Fiske, D. W. (1959). Convergent and discrimination validation by the multitrait multimethod matrix. *Psychological Bulletin*, 56, 81-105

measurement tools are subjective and operate from their own assumption framework.

The subjectivity of triangulation can be minimised in the data analysis framework as suggested by Mengshoel:

*“In a concurrent triangulation design the data analysis strategies of quantitative and qualitative data has also to be connected.”*⁷²³

However, triangulation is not a panacea for all data differences and by itself it does not explain differences it only provides a broader framework for capturing the truth. *“Recognizing the criticism that triangulation fails to fully reflect the co-existence of multiple and perhaps conflicting explanations.”*⁷²⁴

One way to try and strengthen the mixed methods research framework is to apply the principles of triangulation to the methods being used, rather than just focusing on the interpretation of the data results.

⁷²³ Mengshoel. (2012). Mixed methods research - so far easier said than done? *Manual Therapy*, 17, 373-375

⁷²⁴ Modell, S. (2009). In defence of triangulation: A critical realist approach to mixed methods research in management accounting. *Management Accounting Research*, 20(3), 208-221. doi:10.1016/j.mar.2009.04.001 p214

4.6.5.6.1 Method triangulation

Method triangulation is a technique whereby one research method acts to triangulate or validate the findings from another method.⁷²⁵ This has been suggested as a better method for replicating experiments, since exact replication of research methods will possibly contribute to the continued distortion of the results. Modell also reviewed accounting and management research and specifically looked at methods of triangulation between quantitative and qualitative methods. His focus was on the use of case studies to support survey results, a model not too dissimilar to this research design although interviews were used instead of case studies.

4.6.5.6.2 Theoretical triangulation

The research has also incorporated an element of theoretical triangulation⁷²⁶ by choosing to develop a theoretical framework using two main theories (Agency, Criminal Psychology) but also linking this to other prominent theories currently in the field (Systems and Game Theory). Linking empirical studies into current theoretical thinking is one way of ensuring internal validity of the research, which can be a challenge for interpretivist research designs.⁷²⁷ Although as far back as the 1980s

⁷²⁵ Modell, S. (2005). Triangulation between case study and survey methods in management accounting research: An assessment of validity implications. *Management Accounting Research*, 16(2), 231-254. doi:10.1016/j.mar.2005.03.001

⁷²⁶ Modell, S. (2005).

⁷²⁷ Modell, S. (2005).

researchers such as Eisenhardt ⁷²⁸ had developed a framework for developing theoretical models using case studies.

When it comes to applying theory based techniques to describe real world scenarios, Modell issued a warning. In relation to using theoretical triangulation by itself he argues that it is not the universal cure for ensuring research validity, instead it should be used in conjunction with other more empirical based triangulation techniques.

“Even though this does not negate the use of multiple theoretical frameworks to make sense of research findings, such theory triangulation can never produce exhaustive and universally valid conclusions about the ‘real’ world.”⁷²⁹

4.6.5.7 Validity within the research design

One of the key aspects of research design is to ensure that the findings are valid and that they can stand up to outside scrutiny or criticism. In order to achieve this in quantitative research there are usually three types of validity that are considered, these are; internal, external and

⁷²⁸ Eisenhardt, K. M. (1989). Building theories from case study research. *Academy of Management Review*, 14(4), 532-550.

⁷²⁹ Modell, S. (2009). In defence of triangulation: A critical realist approach to mixed methods research in management accounting. *Management Accounting Research*, 20(3), 208-221. doi:10.1016/j.mar.2009.04.001 p211

construct validity.⁷³⁰ However, in qualitative research, which is less scientifically experimental in design and can be more experiential in nature, some of these validity constructs are adapted to suit the nature of the research being considered. Rigour in qualitative research tends to be assessed in terms of trustworthiness which is composed of “*credibility, dependability, confirmability and transferability*.”⁷³¹ Hassen & Keeney also add that in qualitative research dependability tends to replace the quantitative focus of reliability.

4.6.5.7.1 External validity or Transferability

This is usually considered in relation to the applicability of the findings across a broader population, especially where smaller case studies or sample groups have been used. In positivist research this is often done through statistical projections whilst in interpretivist research this has more often been achieved through linking theory and empirical findings. This research has established external validity by using a Delphi approach to establish agreement across a number of sectors and using a broad and multidiscipline group of participants for the two types of survey. It has also employed a research design that combines both the theoretical framework and the empirical focus of the research into one framework.

⁷³⁰ Modell, S. (2005). Triangulation between case study and survey methods in management accounting research: An assessment of validity implications. *Management Accounting Research*, 16(2), 231-254. doi:10.1016/j.mar.2005.03.001

⁷³¹ Hasson, F., & Keeney, S. (2011). Enhancing rigour in the delphi technique research. *Technological Forecasting and Social Change*, 78(9), 1695-1704. doi:10.1016/j.techfore.2011.04.001

4.6.5.7.2 Internal Validity or Credibility

The need for strong internal validity is often considered a prerequisite for acquiring external validity, Eisenhardt⁷³² suggests that by asking the question 'why', and seeking to answer this then internal validity will automatically be developed in exploratory and interpretative research design. Using supportive and contrasting literature is also another way of establishing validity and developing a clearer construct.⁷³³ In their definition of rigour in interpretative design Hassen & Keeney state that conformability tends to replace objectivity in qualitative research. The use of an expert panel, with experience within the sector, was used as one mechanism by which internal validity could be established.

4.6.5.7.3 Construct Validity

Construct validity is seen as the link between theoretical and empirical constructs, so that what is being measured and is witnessed at an empirical level should tally with the theoretical framework being used. This can be challenging when research methods such as the survey method in this study are used, since the respondents represent a cross

⁷³²Eisenhardt, M. (1989). Agency theory: An assessment and review. *Academy of Management. The Academy of Management Review*, 14(1), 57-74

⁷³³Eisenhardt, M. (1989). Agency theory: An assessment and review. *Academy of Management. The Academy of Management Review*, 14(1), 57-74

section of sectors each one of which represents a very different construct reality. In business the operating constructs have to be established since businesses do not operate by themselves ⁷³⁴ the same principal also applies to the banking sector which is a business context.

Constructs are unlikely to remain the same for very long since they are constantly adapting and changing according to their environment,⁷³⁵ this is one of the arguments against exact replication research since the social constructs being measured can never be the same.

“The typical means of addressing construct validity issues in triangulated research following a theory testing logic is to rely on some qualitative inquiry prior to the distribution of surveys, occasionally as an integral part of empirical development of hypotheses to be tested in subsequent phases.”⁷³⁶

In this research the qualitative inquiry method that was used to determine the construct in the primary data collection phase, was through the experts who were invited and recruited onto the expert panel. The experts were then asked to review the proposed survey questions and

⁷³⁴ Nørreklit, H., Nørreklit, L., Mitchell, F., & Bjørnenak, T. (2012). The rise of the balanced scorecard! Relevance regained? *J Acc & Organizational Change*, 8(4), 490-510. doi:10.1108/1832591121127349

⁷³⁵ Modell, S. (2009). In defence of triangulation: A critical realist approach to mixed methods research in management accounting. *Management Accounting Research*, 20(3), 208-221. doi:10.1016/j.mar.2009.04.001

⁷³⁶ Modell, S. (2005). Triangulation between case study and survey methods in management accounting research: An assessment of validity implications. *Management Accounting Research*, 16(2), 231-254. doi:10.1016/j.mar.2005.03.001 p237

confirm that the relevant issues were being covered from a number of discipline perspectives, before they were widely disseminated. For the review of secondary data, the use of coding software to deconstruct some of the textual and thematic constructs was used, and then explored further where necessary through email interviews with the relevant experts across different sectors.

4.6.5.8 Limitations

The research is fairly innovative and therefore leading out into uncharted waters. The research methods employed in this study have illustrated research innovation and provided the opportunity to engage with experts on this topic from across the globe. However, there are limitations to using this approach and these have been identified in this section.

4.6.5.8.1 Number of Experts

Firstly, although the range of expertise involved in this project is fairly representative both geographically and from across a number of different sectors, it is still not all inclusive. Some sectors especially within AML intelligence were not easy to acquire any information from and yet these would be lead players in the ultimate prosecution of cases and

would have more insight into the legal barriers and challenges to be encountered. However, there were over 20 members involved on the expert panels and this is perhaps more than most Delphi models use.

“The Delphi group size does not depend on statistical power, but rather on group dynamics for arriving at consensus among experts. Thus, the literature recommends 10-18 experts on a Delphi panel.”⁷³⁷

4.6.5.8.2 Internal Audit

Secondly the focus of the research included a section on the role of internal audit within the banking context. However, it became evident through out the research process that many people felt internal audit did not really have a substantial role and would not necessarily be involved in the development of a risk framework. This is obviously one area of thinking that the research hopes to challenge, given the expected role that FATF ⁷³⁸ and other industrial leaders in this area are suggesting needs to be developed further for Internal Audit. Other academics and internal audit analysis ⁷³⁹ have suggested that internal audit is ideally placed to discover

⁷³⁷Okoli, C., & Pawlowski, S. D. (2004). The delphi method as a research tool: An example, design considerations and applications. *Information & Management*, 42(1), p 19

⁷³⁸FATF. (2010). Money laundering vulnerabilities of free trade zones. Paris: FATF/OECD.

⁷³⁹Elbardan, H., Ali, M., & Ghoneim, A. (2015). The dilemma of internal audit function adaptation: The impact of ERP and corporate governance pressures. *Journal of Enterprise Information Management*, 28(1), 93-106

red flags in fraud ⁷⁴⁰ and PwC recently suggested that internal audit had a valuable role to play in AML compliance.⁷⁴¹ The subsequent lack of inclusion of internal audit respondents in this research did mean that opinions on the role of internal audit were not very well considered. In part this is probably as PwC state that they currently do not engage very much in the TBML monitoring process at the moment.

4.6.5.8.3 Online Engagement

The use of international participants in the survey and expert panel meant that there was no face to face interaction. This made encouraging people to engage with on line surveys and email requests or questions quite difficult and does not suit the way some people prefer to work. As previous research suggested ⁷⁴² the non-response rate is a lot higher for on-line surveys and this meant that a very large initial selection group was required, which was being drawn from a sector that even globally was quite small.

⁷⁴⁰ Norman, C. S., Rose, A. M., & Rose, J. M. (2010). Internal audit reporting lines, fraud risk decomposition, and assessments of fraud risk. *Accounting, Organizations and Society*, 35(5), 546-557.

⁷⁴¹ PwC. (2014). Internal audit holding the line on BSA/AML compliance. Retrieved from <http://antimoneylaundering-fiba.com/files/1499.pdf>

⁷⁴² Dillman, D. A., Phelps, G., Tortora, R., Swift, K., Kohrell, J., Berck, J., & Messer, B. L. (2009). Response rate and measurement differences in mixed-mode surveys using mail, telephone, interactive voice response (IVR) and the internet. *Social Science Research*, 38(1), 1-18

4.6.5.8.4 Access to Banking Officials

One of the challenges that always faced the research was the possible lack of engagement by banking officials, including internal audit and AML compliance / money laundering reporting officers (MLROs). This had been initially addressed by specifically targeting members of ACAMS (Association of Certified anti-Money Laundering Specialists) who are already engaged in discussions on money laundering activities and who are already publicly speaking about the issue. However, the research failed to engage with ACAMS staff who did not view supporting external research as part of their remit. Instead the research expanded its recruitment scope and also targeted banking institutions that had connections to the university business schools, and managed to reach the MLROs through this process. In addition the broader financial services TBML and AML experts would also be involved in the questionnaires/interviews as well as AML experts from across other areas such as law enforcement and regulatory bodies. In addition, secondary data was used as a verifying triangulation method to provide supportive information. This information was already being supplied to banking institutions on AML practices and is available in the public domain.

4.6.5.8.5 Trade Data and links to Customs Officials

The focus of the research is on the banking context; however, one of the major agencies involved in TBML activity is obviously customs and

excise, who hold a lot of information on trade data.⁷⁴³ However, it is beyond the scope of this project to analyse the content of trade data in any great detail. The purpose of this research will be to identify gaps in banking knowledge and areas for collaboration. It is possible that further additional research will be needed to look at ways in which customs and global banks could work closer together.

⁷⁴³ Zdanowicz, J. (2009). Trade Based Money Laundering and Terrorist Financing. *Review of Law and Economics* Vol 5 No.2, 855-878

4.7 ETHICAL CONSIDERATIONS

The research involved primary data collection from individuals working in the banking and anti-money laundering fields. The research also worked collaboratively with a number of other academics and experts across the field. The major tenets of ethical collaboration were used such as honesty, integrity, trust, accountability, mutual respect and fairness. Another reason that an ethics code is important is due to the nature of the research approach. As a social science project situated in a real life operational situation, the ethical concept of maintaining complete independence and objectivity is harder to achieve than in a laboratory setting. However, it has been suggested that laboratory values of objectivity and independence are not as useful in a social science setting, since they do not explain the actual phenomenon being observed.

“Here the main claim is that although notions of independence and objectivity might assist our understanding the natural and physical world, it is ill-suited to the social and organisational context where most activity occurs.”⁷⁴⁴

Subjectivity and researcher bias are two elements therefore that need to be minimised rather than eliminated. To achieve this the research produced its own code of ethics for collaboration that was shared with all participants involved in the project. The code is based upon the work of

⁷⁴⁴ Brocklesby, J. (2009, p1074)

both the Code of Ethics for the British Psychological Society ⁷⁴⁵ as well as endorsing the current code of ethics of the University. The need for an ethics code is especially important given the nature of the research material and the potential sensitivities of people that will be involved in this research project. In particular, this research focuses on outcomes to address criminal activity, including money laundering and tracking sources of terrorism funding. Therefore, an element of ethical sensitivity is required throughout the research, a term that according to Jagger and Volkman is “*the development of moral sensitivity.*” ⁷⁴⁶ In other words recognising where ethical dilemmas might exist and being able to make decisions that are morally and ethically appropriate.

Brocklesby also highlights one of the key tenants of ethical social research, which is when considering which methods to use the researcher should remain open minded as much as possible, to choosing the most appropriate methods for the design of the project.

*“One of the ground rules for ethical social engagement that is implicit in the “ethics beyond... ” approach, is that when presented with the opportunity to influence how a problem such as this is framed and advise on an appropriate methodology, the agent will be reasonably open-minded.”*⁷⁴⁷

⁷⁴⁵ BPS. (2014). BPS code of human research ethics. Leicester: British Psychological Society

⁷⁴⁶ Jagger, S., & Volkman, R. (2014). Helping students to see for themselves that ethics matters. The International Journal of Management Education, 12(2), p184

⁷⁴⁷ Brocklesby, J. (2009). Ethics beyond the model: How social dynamics can interfere with ethical practice in operational research/management science. Omega, 37(6), p1076

The choice of the Delphi approach was deemed the most appropriate because it addressed some of the key concerns of the project, such as collecting a diverse and cross section of views and trying to avoid bias when analysing the responses. Some of the other key points considered in the research ethical consideration are discussed below.

4.7.1 Voluntary Informed Consent

All participation in the research is voluntary and therefore actively completing the surveys or agreeing to participate in the interviews has been deemed as consent for that participant. In order to prepare and fully brief any potential participant, all participants in the research were offered the opportunity to review the research proposal and to offer suggestions for amendment or change. An invitation was made in writing by email to all potential expert participants to become a member of the expert panel and also to participate in the semi-structured interview. Many of the experts are academic writers working in TBML or closely aligned areas of interest such as financial fraud and anti-terrorism initiatives. They have volunteered their time and input after having been approached as a fellow researcher seeking advice and support in a specialised area that could potentially link into their own work at a later stage. For future participants not involved in the expert panel this will just involve participating in the survey process.

Participants on the expert panel will also be offered the opportunity to review the proposed empirical risk assessment model being developed through the research findings, and they will be able to provide feedback and suggestions for change before it is finalised. All experts will have the right to be named or retain anonymity throughout the research project.

4.7.2 Confidentiality

The topics covered by the research are potentially very sensitive and difficult subjects to acquire information on or for people working in these areas to agree to participate in a research project such as this. Secondly the highly politicised impact of the findings on the crimes and criminals associated with providing illicit money, mean that confidentiality of sources and the need to present the findings in a politically sensitive manner are all areas that need to be considered by the researcher.

All participants will have the right to highlight information that cannot be published even if it is shared with the researcher, and agreement will be made between the researcher and participant as to how the information can inform the research and recommendations / model design even if it is not included as a primary source of data. The ethics code will also outline procedures for responsible data management, data sharing, guidelines on authorship, confidentiality rules and data sharing policies. All participation in the research will be voluntary.

4.7.3 Anonymity

The research ensures anonymity within case study description especially detailing specific communities and individual identities. It also seeks to portray a balanced global perspective on the issue of AML compliance, rather than highlighting all bad examples for one jurisdiction compared to positive cases in another area. The concept of objectivity is important in the research because it has to cross several different disciplines and be able to translate into their areas of expertise, therefore assumptions and subjective approaches taken by one discipline will not be easily acceptable without justifications in other areas of expertise.

The research topic also covers sensitive political areas such as links to terrorism activities which also has the potential to perpetuate myths associated with racial profiling. This research will need to ensure that negative stereotypes associated with particular countries and ethnic groups are not reiterated in the research.

All interview responses are reported anonymous, but according to the sector represented. Interview data and identity are known to the researcher and supervisor to ensure validity and authenticity of data with a codification system in place for referencing between researcher/supervisor. However, this information will not be shared with anyone else.

4.7.4 Right to Withdraw

There are a number of reasons why participants may decide to withdraw from the research process. In this research the main reasons are; confidentiality of information and possible conflict between maintaining confidentiality at work and sharing data or information with ourselves in the project. Secondly the secrecy component of the work and the impact on security and risk within the bank may cause some participants to review their level of participation in the project. Finally, staff and/or their workplace may decide that too much additional work is currently being carried out and some projects have to be withdrawn from.

All participants were informed of this at the start and throughout the process. In addition, there are a number of options available to participants, so that if experts needed to pull back on their commitment they could opt out at any stage to only undertake an interview or to withdraw completely. The research does not depend exclusively on continued participation by everyone, nor is there any detriment to the research if participants join later on in the project, rather than at the beginning of the data collection period. The reason for this lies partly in the design of the research, which utilises a Delphi model of analysis and therefore relies on a number of individuals across differing areas of expertise, rather than relying on only one or two individuals. Secondly the nature of expertise required will vary at different times in the research write up and analysis stages. Therefore, expertise may only be required at a

specific point and not on a continuous basis throughout the entire research project, e.g. to understand a specific legal process, or to acquire access to certain cases or information.

4.7.5 Detriment Arising From Participation in the Research

The political sensitivity of the data has raised concerns about gaining access to various sources such as banking institutions, who would be seriously compromised if they acknowledged that they were knowingly not complying with legislation or AML principles. However, the research is operating from a voluntary disclosure approach and the information is confidential and also not specific enough to have any legal ramifications. Participants are aware in the course of their work that many of the recommendations on AML compliance are still at the recommendation stage rather than legally binding, therefore disclosures made to the project of this nature could be assured confidentiality of the participant.

4.7.6 Feedback to Participants

The research has incorporated a Delphi methodology for data analysis to ensure that expert participants have the opportunity to offer feedback and amend suggestions arising from the research. This has also been done to ensure relevance across a number of different disciplines.

Any participant who will be included in the interview process will be informed of the purpose of the research and will have already participated in the survey.

In return all participants and contacts made during the research process will similarly be expected to openly declare their intention in using or promoting any aspect of the research findings.

4.7.7 Dual Role of Practitioner and Researcher

One element of potential bias from the researcher is in the adoption/definition and understanding of money laundering. Government sources are very emphatic that money laundering is a crime that has to be stopped by banks. However, this is not an opinion that is supported in every country. In many countries the legal definition is the means by which the money was acquired, that is the crime not the method by which it enters the financial system.⁷⁴⁸ This has been the position of banks for many years but this is now being challenged through the regulatory bodies. It is important for a sense of realism that all participants in the research are able to accurately reflect on their organisation's position

⁷⁴⁸ "It follows from the simple definition above that money laundering cannot occur without being preceded by a crime which gives rise to the illegally obtained funds. Such crimes are called 'predicate crimes'. Countries differ in what they define as predicate crimes and what they define as money laundering. Each country's definition is critical because if a crime is not a predicate crime then there is no money laundering activity" taken from "Module 3: Notes Money Laundering and Terrorist Financing – Definitions and Nature" of Advanced Certification in Anti Money Laundering. International Compliance Training Ltd England. Source: www.int-comp.com/members/attachments/Mal-module3.pdf

without risk of compromising their relationship with government, state or regulatory bodies, or endangering the political fallout from seeming to be out of sync with other financial services.⁷⁴⁹

4.7.8 Personal Safety

The research participants are all professionals working in the sector of AML in some capacity; most of them are working or aligned to the research sector and as such would be very familiar with research ethical guidelines.

Telephone and electronic contact were the primary source of material used and communication system in operation.

4.7.9 Challenges in research ethics

One of the biggest challenges facing researchers, especially in today's electronic and virtual world are the issues of confidentiality and retaining privacy of information.⁷⁵⁰ The information that is available and which can be quickly accessed through the internet and social media is a lot easier today than in the era of more traditional research.

⁷⁴⁹ "The differences between countries on these key definitions make international cooperation difficult in circumstances where countries do not recognise the same crimes as predicate crimes" taken from page 88 "Module 3: Notes Money Laundering and Terrorist Financing – Definitions and Nature" of Advanced Certification in Anti Money Laundering. International Compliance Training Ltd England. Source: www.int-comp.com/members/attachments/Mal-module3.pdf

⁷⁵⁰ Hoser, B., & Nitschke, T. (2010). Questions on ethics for research in the virtually connected world. *Social Networks*, 32(3), 180-186

“While in the real world social standards and laws have been fought for and established to allow the individual to live (at least mostly) unintruded, these laws and standards have not been generally adapted to the virtual world. This holds for everyday life as well as for research .”⁷⁵¹

4.7.10 Timeline

The research primary data collection was conducted over a 12-month period. The overall time span for conducting the research project was three years. Media case studies and empirical studies that were used as part of the secondary data were all taken from within the last 10 years. The research has used a cross sectional time horizon, with specific emphasis on the last 10 years for reviewing media and current professional perspectives on AML compliance within the global banking sector.

4.7.10.1 Ten Year Time Scale

The reason for choosing a narrow timescale of 10 years (2005-2015) was because money laundering is a relatively new area of regulation and compliance for the banking sector and to maintain up to

⁷⁵¹ Hoser & Nitschke (2010, p180)

date relevance. A number of media cases emerged during the course of this study, which related to the time period 2007/8 and so it seemed logical to include material from within this period. In addition, developments in modern technology have been influential in causing or facilitating the increase in TBML opportunities, due to the increase in shipping routes and the ongoing regular increase in international trade. It was therefore also a logical decision to focus on the more immediate timescale and review how the technology revolution and increase in shipping routes has impacted on money laundering techniques. The third reason for a narrow timescale was that the predicted outcome of the research would be a risk assessment tool that could be used for future money laundering assessment. This meant that current and future issues were the immediate priority for the research rather than too many historical events.

4.7.11 Historical Cases

The media cases relating back to 2007 such as the HSBC Swiss leaks ⁷⁵², the HBUS case in the US ⁷⁵³ and the more recent Panama papers ⁷⁵⁴ have all emerged within the last 5 years into the public domain. The papers provided an in-depth analysis of the consequences of some of the checking practices that the banking sector were involved in, and they

⁷⁵² ICIJ (2015) Swiss leaks: Murky cash sheltered by bank secrecy <http://www.icij.org/project/swiss-leaks/banking-giant-hsbc-sheltered-murky-cash-linked-dictators-and-arms-dealers>

⁷⁵³ Homeland Security. (2012). HSBC exposed US financial system to money laundering, drug, terrorist financing risks. From permanent sub committee on investigations. US Senate. Retrieved from <http://www.hsgac.senate.gov/subcommittees/investigations/media/hsbc-exposed-us-financial-system-to-money-laundering-drug-terrorist-financing-risks>

⁷⁵⁴ ICIJ (2016) The Panama Papers <https://panamapapers.icij.org> accessed 30th June 2016

offered insights into AML risk assessment processes generally during this time. They were used in this thesis because of the level of insight they provided into the banking culture towards AML compliance during these periods of time. They also offered banks the opportunity to highlight what changes had occurred since this period and to provide a deeper level of awareness of AML actions currently taking place. This information was politically sensitive and would have been difficult to ascertain otherwise. The cases that were used through typology studies were more recent and focused on current reports as they emerged within the years of publication between 2012⁷⁵⁵ and 2015⁷⁵⁶.

The Financial Action Task Force reports on TBML were also written at the earlier time in 2006 and 2008. Many banks are therefore still operating on systems and thinking from within this earlier period and it was deemed important by the research to include all of this in the analysis.

4.7.12 Techniques and Procedures

In Eisenhardt's (1989) framework for using case studies to develop theory, she advocates the need for a research strategy that uses multiple methods. This strategy was adopted in the research design with the overlapping of the data collection and data analysis stages. This meant that emerging insights could be used in the final data analysis process.

⁷⁵⁵ APG. (2012). APG Typology Report on Trade Based Money Laundering. Sydney: Asia Pacific Group on Money Laundering

⁷⁵⁶ PwC. (2014). Goods gone bad. Addressing money-laundering risk in the trade finance system

This method was considered to be especially relevant in this research since there was the possibility to consider interviews as a way to strengthen the findings from the survey or earlier email conversations.

4.7.12.1 Data Collection Methods

The methods that were chosen for the data collection were selected to support the nature of the research questions, which were empirical and considered the global perspective of money laundering and TBML issues across the banking sector. The first priority was to collect the views of those working in the sector from both a banking perspective and also from a financial intelligence and analysis perspective and develop a broad level of information across the entire sector.

4.7.12.2 Broad Information Outcomes

There were three main outcomes expected from the broad level data, firstly it would enable the research to determine what and how the current approaches to money laundering risk assessment were being used. Secondly it would enable the research to determine where the practitioners, rather than the regulators, felt the gaps were in assessing for money laundering risk. Finally, it would enable the research to see what other issues were being identified as problematic in the AML compliance sector.

In the literature review a number of the empirical research documents studied included financial crime surveys from various external accounting companies.⁷⁵⁷ However, many of these were also aiming to highlight gaps in the sector for which these companies had already established an area of expertise⁷⁵⁸ or had a particular interest in promoting.⁷⁵⁹ Therefore, it also follows that if the auditing or accountancy company was not working in a particular problem area of AML compliance they were unlikely to highlight this as an issue. In order to address this potential bias across the current empirical data, the research wanted to run its own consultation survey and to focus it specifically on the banking environment and on the issues of TBML. This would afford respondents from within the banking sector, their own opportunity to state the AML issues and priorities as they saw them, i.e. irrespective of what issues had been previously identified in other surveys.

4.7.12.3 In-depth Information outcomes

The second priority was to explore the key themes that emerged from the broad level data and to examine this in more detail. This would require extracting a greater level of detail and opinions from key experts who had experience in this type of work. This presented two challenges for

⁷⁵⁷ KPMG. (2013). Global anti-money laundering survey.

KPMG. (2014). Global anti-money laundering survey

⁷⁵⁸ PwC. (2014). Goods gone bad. Addressing money-laundering risk in the trade finance system.

⁷⁵⁹ PWC. (2014b). Internal audit holding the line on BSA/AML compliance. Retrieved from <http://antimoneylaundering-fiba.com/files/1499.pdf>

the project, firstly how to determine who held this information and secondly how to access the data if it was too sensitive to be published publicly.

4.7.12.4 Technology

Finally, for each of the different elements of the data collection, the use of technology and the internet were also influencing factors in deciding on the most appropriate approach. The many advantages of internet based technology on research design such as increased sample size and diversity, reduced administration, and innovative data analysis tools are equally met with the disadvantages of new techniques. Amongst these disadvantages is included that there is less research on these topics and therefore less acceptance, due to limited reports on the validity and reliability in using these systems.⁷⁶⁰ This point is highlighted in Dillman and Smyth's commentary on using web based surveys with health practitioners.

*"The challenge for web surveyors in general and eHealth methodologists in particular is that the body of research addressing how survey error is affected in web surveys is in its infancy."*⁷⁶¹

⁷⁶⁰ Cole, Z. D., Donohoe, H. M., & Stelleson, M. L. (2013). Internet-Based delphi research: Case based discussion. *Environmental Management*, 51, 511-523. doi:10.1007/s00267-012-0005

⁷⁶¹ Dillman, D. A., & Smyth, J. D. (2007) p90

The research therefore had to balance using innovative research techniques alongside maximizing the use of technology, in a way that wouldn't be detrimental to the overall project outcomes.

4.7.13 Sampling technique

The first challenge for the research data collection was to develop a sampling strategy that would be representative of the sector.⁷⁶² Although experimental research is often associated with random sampling in reality even within quantitative research design this is not entirely true for all projects, Polit and Beck⁷⁶³ went as far as to describe it as a myth that quantitative research uses random sampling stating that random sampling rarely produces random samples. In this research the aim was to capture the key experts in the field of TBML, and so the research design incorporated a selective expertise focused, sampling strategy. This strategy was developed by developing a database of existing contacts and names from published journal articles and reports on any of the following subjects;

1. Trade based money laundering
2. Money laundering
3. AML compliance and regulation

⁷⁶² Dillman, D. A., & Smyth, J. D. (2007). Design effects in the transition to web-based surveys. *American Journal of Preventive Medicine*, 32(5 Suppl), S90-6. doi:10.1016/j.amepre.2007.03.008

⁷⁶³ Polit, D. F., & Beck, C. T. (2010). Generalization in quantitative and qualitative research: Myths and strategies. *International Journal of Nursing Studies*, 47(11), 1451-8. doi:10.1016/j.ijnurstu.2010.06.004

4. Financial crime

5. Internal Audit and compliance

Experts were emailed and from this initial contact other names were also suggested which developed as a snowballing technique. Once experts were chosen from their relevant research areas and agreed to be contacted, they were asked to review the research proposal. If they were still interested they were invited to become part of a research expert panel, which would be involved in reviewing the research recommendations or models of risk assessment, from the perspective of their own area of expertise.

As part of the introductory email experts were also invited to suggest changes or amendments to the proposal. During this process new names of colleagues or authors and papers, not already being used, were offered by some of the experts as potential allies who might be interested in becoming involved in the project. There was a lot of enthusiasm for the project although many respondents did not identify well with the title 'expert'.

4.7.13.1 Broad level sample

Once the broad level data collection tools were developed in the form of the online survey,⁷⁶⁴ then experts were asked to encourage other relevant colleagues and contacts working in the area to complete the form. This also encouraged an expertise focused snowball effect that was part of the overall Delphi design.⁷⁶⁵ This enabled an expert led approach to recruiting participants, that were deemed as relevant by the panel. One of the disadvantages of web based surveys is that literature pertaining to possible errors and weaknesses in design are relatively few “*there is little information about the effects of using techniques developed for use in other modes or of using new web innovations on survey error in web surveys.*”⁷⁶⁶ There is also very little literature dealing with sampling techniques for use in web based surveys. However, some researchers such as Chizawsky and Estabrooks have suggested using a mixed method approach with web surveys,⁷⁶⁷ as one way to ensure rigor whilst also introducing a triangulation method into the research design. The mixed method approach suggested by Chizawsky and Eastabrooks was adopted in this research study whereby web based surveys were supported by web based interviews and case study analysis. This meant that a system of triangulation was created that enabled the researcher to cross reference opinions and thoughts in the survey alongside published

⁷⁶⁴ Dillman, D. A., & Smyth, J. D. (2007). Design effects in the transition to web-based surveys. *American Journal of Preventive Medicine*, 32(5 Suppl), S90-6. doi:10.1016/j.amepre.2007.03.008

⁷⁶⁵ Geist, M. R. (2010). Using the delphi method to engage stakeholders: A comparison of two studies. *Evaluation and Program Planning*, 33(2), 147-54. doi:10.1016/j.evalprogplan.2009.06.006

⁷⁶⁶ Dillman, D. A., & Smyth, J. D. (2007). Design effects in the transition to web-based surveys. *American Journal of Preventive Medicine*, 32(5 Suppl), S90-6. doi:10.1016/j.amepre.2007.03.008

⁷⁶⁷ Chizawsky, L. L., Estabrooks, C. A., & Sales, A. E. (2011). The feasibility of web-based surveys as a data collection tool: A process evaluation. *Applied Nursing Research: ANR*, 24(1), 37-44. doi:10.1016/j.apnr.2009.03.006

research, media coverage of case studies and also to ask additional questions on emerging themes in the interview section.

4.7.13.2 In-depth level sample

A convenience sampling combined with an expert focused method was used to select the interview participants. The reason for the two methods is perhaps contrary to traditional convenience sampling methods whereby *“In convenience sampling no inclusion criteria identified prior to selection of subjects. All subjects are invited to participate.”*⁷⁶⁸ However, the larger pool of respondents was all selected using an expert focused approach in the broad level data collection, and it was from within this group that a smaller group of experts, who agreed to participate, were selected for the in-depth sample. All participants on the expert panel had the option of becoming involved in the interview process, However, due to a number of factors such as; work schedule or experts feeling they had a lack of specific banking TBML expertise not everyone availed of the process.

Overall the two sampling structures seemed to target the right level of expertise, the referral and snowballing techniques was used until a saturation level was reached, whereby no new names were being suggested any more. In order to facilitate this process and the time lag for as long as possible both data collection systems were left running for several months.

⁷⁶⁸ Research Methodology (2015) Convenience Sampling <http://research-methodology.net/sampling/convenience-sampling/>

4.7.13.3 On-line Survey

An online survey was seen as the best method for reaching as broad a range of participants as possible from across the globe, especially when they were also travelling and operating from a range of different time zones. Most of the contact with the expert panel had been through email and initially it was thought that a survey could be emailed to potential participants. However, the practical difficulties with this approach were quickly realised during a pilot run ⁷⁶⁹ which highlighted a number of challenges to using this approach.

1. There were differences with the presentation of the data results and how participants decided to fill in the form.
2. This also caused problems with a preliminary analysis of the data that would be sometimes incomplete or unclear as to which options had been chosen.
3. It was also established as a cumbersome method, relying on the participant to download the form, work out how to electronically complete the questionnaire and to then promptly send it back.

From this pilot scheme an electronic version of the survey was produced using smartsurvey.co.uk, which meant that links to the survey could be posted through email and results filled in online in an easy to use and regulated format. Initial analysis was also completed through the

⁷⁶⁹ At the very start the initial questions were emailed to several experts on the panel to test run.

software and incomplete surveys were easy to notice and were not included in the final compile.

The pilot survey used four different formats of survey to see which one's people felt were most relevant. The four options covered all the main differences across the various groups involved in TBML, and linked to the banking context. In the end two surveys were finally agreed upon; one dealing with banking specific questions and dealing with the identification and collection of data for suspicious activity reports. The other survey was for those working on the analysis of the suspicious alert data, such as financial intelligence units, law enforcement or in large banks, where analysts might do this work.

Current research has continued to monitor the advantages between the two types and initially web based surveys were associated with higher response rates compared to other kinds of survey method.⁷⁷⁰ However, other research has suggested that this trend could be reversing since some current online surveys do not always seem to have the same margin of success in response rates over postal and email surveys.⁷⁷¹

⁷⁷⁰ Sánchez-Fernández, J., Muñoz-Leiva, F., & Montoro-Ríos, F. J. (2012). Improving retention rate and response quality in web-based surveys. *Computers in Human Behaviour*, 28(2), 507-514. doi:10.1016/j.chb.2011.10.023

⁷⁷¹ Hardigan, P. C., Succar, C. T., & Fleisher, J. M. (2012). An analysis of response rate and economic costs between mail and web-based surveys among practicing dentists: A randomized trial. *Journal of Community Health*, 37(2), 383-94.

Akl, E. A., Maroun, N., Klocke, R. A., Montori, V., & Schunemann, H. J. (2005). Electronic mail was not better than postal mail for surveying residents and faculty. *Journal of Clinical Epidemiology* 58(4), 425-429.

“Response rates were best for the mail (26%) with the worst response rate coming from the web group (11%).”⁷⁷²

These results are important to acknowledge since a good response rate is one of the key aspects of a successful survey, with higher numbers preferred in order to avoid or eliminate response bias.⁷⁷³ However, the evidence from studies regarding response rates for online surveys seems to depend on whether they are part of mixed survey designs⁷⁷⁴ or whether follow on contact is part of the research design.⁷⁷⁵ Some evaluative research even states that there is no difference in research responses between mail, telephone or on-line.⁷⁷⁶ There are also other differences that have been noted in using web based surveys such as that the responses received in one form of survey will be different when received in other types.⁷⁷⁷ It ultimately seems to depend on the preference of the respondent and the persistence and support offered by the researcher. As with all surveys there will be a non-response group.

⁷⁷² Hardigan, P. C., Succar, C. T., & Fleisher, J. M. (2012). An analysis of response rate and economic costs between mail and web-based surveys among practicing dentists: A randomized trial. *Journal of Community Health*, 37(2), p383

⁷⁷³ Shih, T., & Fan, X. (2009). Comparing response rates in e-mail and paper surveys: A meta-analysis. *Educational Research Review*, 4(1), 26-40

⁷⁷⁴ Beebe, T. J., Locke, G. R., Barnes, S. A., Davern, M. E., & Anderson, K. J. (2007). Mixing web and mail methods in a survey of physicians. *Health Services Research*, 42(3 Pt 1), 1219-34

⁷⁷⁵ Chizawsky, L. L., Estabrooks, C. A., & Sales, A. E. (2011). The feasibility of web-based surveys as a data collection tool: A process evaluation. *Applied Nursing Research: ANR*, 24(1), 37-44. doi:10.1016/j.apnr.2009.03.006

⁷⁷⁶ Akl, E. A., Maroun, N., Klocke, R. A., Montori, V., & Schünemann, H. J. (2005). Electronic mail was not better than postal mail for surveying residents and faculty. *Journal of Clinical Epidemiology*, 58(4), 425-429

⁷⁷⁷ Dillman, D. A., Phelps, G., Tortora, R., Swift, K., Kohrell, J., Berck, J., & Messer, B. L. (2009). Response rate and measurement differences in mixed-mode surveys using mail, telephone, interactive voice response (IVR) and the internet. *Social Science Research*, 38(1), 1-18

4.7.13.3.1 Reasons for Using an Online Survey

There were other reasons for using an on-line survey design that this research was trying to utilise;

1. Firstly, the capacity to reach a wider audience especially overseas and in different time zones was a distinct advantage though an online system. The instant analysis of basic statistics in order to provide the researcher with immediate feedback on the types and background / sector that the respondent was from was very useful especially for guiding the follow up emails.
2. The initial questionnaires were piloted by email but these were not so easy to fill out, and if questions were left blank it was unclear whether this was deliberate or accidental. The online survey design ensured that a response of some kind was mandatory for all questions and the survey couldn't be submitted until this had been complied with.
3. Finally, in terms of administration and cost the research found the web based survey to be a cheaper and less time consuming approach to develop and administer, a finding which was supported by other research such as Hardigan, Succar & Fleischer.⁷⁷⁸ They had calculated that online surveys were 2.68 times cheaper than postal surveys.
4. The time that was saved in design was diverted into follow up and asking respondents to help source other potential experts that might be interested in completing the questionnaire.

⁷⁷⁸ Hardigan, P. C., Succar, C. T., & Fleisher, J. M. (2012). An analysis of response rate and economic costs between mail and web-based surveys among practicing dentists: A randomized trial. *Journal of Community Health*, 37(2), 383-94.
Hardigan, P. C., Succar, C. T., & Fleisher, J. M. (2012).

4.7.13.4 Semi-Structured Interviews

One of the challenges that the research design had to address was the problem that TBML activities were monitored across a variety of professional bodies, some of which have direct links to the banking and financial sectors and others that operated completely outside this sector. Those organisations with connections to the banking sector include external audit companies, law enforcement organisations and regulatory bodies as well as industry based AML consultants. The research questions were focused specifically on the banking context so the sample of experts were restricted to include those either working within the banking and financial services sector, or those that worked closely with them in relation to detecting money laundering.

The interview questions were designed to follow on from the survey themes and both sets of data were linked to answering and developing understanding in relation to the research questions.

“Your research questions formulate what you want to understand: your interview questions are what you ask people in order to gain that understanding.”⁷⁷⁹

This process had the advantage that all potential interview respondents knew what topics would be covered in the interviews and

⁷⁷⁹ Maxwell, J,A (1996) Qualitative Research Design: An interactive approach London: Sage Publications p74

could make a self-selection decision as to whether this was an area of their expertise suitable for a research project.

4.7.13.4.1 Telephone and email interviews

The research had to use telephone interviews rather than meet respondents face to face, this was mainly for logistical reasons since most experts lived in other countries around the globe. There are advantages to face to face interviews that cannot easily be replicated in telephone interviews, such as reading facial expressions and responding to non-verbal cues.⁷⁸⁰ However, the practical realities meant that the research design had to accept this potential limitation in order to ensure adequate representation from across all sectors.

There were initially potential difficulties because some individuals preferred to receive a list of the questions beforehand and then decided to answer the questions by email directly rather than engage in a telephone conversation, especially when time zones were very different or the experts were travelling. The email interview system did however, work better for the researcher because the telephone interview answers had to be written up, and then approved by the respondent before the information could be used in the analysis, and not all participants were that quick at replying to the verification emails.

⁷⁸⁰ Robson, C (2002) *Real World Research* (2nd ed.) Oxford: Blackwell Publishing

4.7.13.4.2 Participants

All of the interview participants had already completed the on-line survey before being selected for the interview process. After being identified they were asked to agree to participate in a follow on semi-structured telephone interview. These interviews were designed to facilitate a greater depth of understanding on the core themes already covered in the on-line survey. The information through the interviews was still to be gathered from across the different expert groupings, so that there was a cross section of representation from amongst the different agencies and countries.

4.7.13.4.3 Case Studies

In addition to participating in the interview process members of the expert panel were also asked to identify any gaps in the research or to pass on any emerging information of relevant cases. This process enabled the researcher to access information on legal proceedings that may have been missed and to search for specific cases that were deemed relevant by different experts. Other academic articles and authors were also suggested from across a number of disciplines, which again facilitated the research process.

4.7.13.4.4 Time Management

The high level of email correspondence between the researcher and more than 50 different experts from across the globe had a large impact on the researcher's time. And their management of correspondence data. This was deemed to be a worthwhile investment but would need to be noted for others wishing to replicate such an approach. A number of software applications⁷⁸¹ were used in order to facilitate this process. These included a dedicated email account established just for the research project. A data software package called DevenThinkPro whereby a file could be developed for every member of the expert panel, with a list of all the email correspondence included in this. A note taking software app Evernote was used to facilitate and record any discussions and follow up actions to take and which could be linked to either a mobile phone or a laptop. This was in addition to the Literature software package called Sente6, which enabled text to be highlighted and electronic notes made as papers were read, as well as an easy copy and paste of references for Oxford style formatting.

The web based survey was administered using smartsurvey.co.uk and links to the survey were emailed to all participants. The use of a professional company for the survey helped to establish trust and present

⁷⁸¹Cole, Z. D., Donohoe, H. M., & Stelleson, M. L. (2013). Internet-Based delphi research: Case based discussion. *Environmental Management*, 51, 511-523. doi:10.1007/s00267-012-0005-5

an easy to use format that all respondents could use.⁷⁸² This was recognized as an important way of both maximizing respondent engagement and also minimizing user error in the survey.

“What they can do though is design user-friendly surveys that minimize measurement error based on what is known about respondent processing and response behaviour once inside the survey instrument.”⁷⁸³

4.7.13.5 Secondary Data Collection

The research project topic was relatively new and finding expertise on the subject matter was challenging given the limited sources available. In order to expand the knowledge base and also to gain access to information that might otherwise be considered too sensitive for research purposes, a number of secondary data sources were used that had already been released into the public arena. These included a number of AML banking legal cases covered in the media as well as the analysis of annual reports and FIU typology reports. These articles and reports were analysed for two main reasons, firstly as secondary data because of the empirical examples they provided and secondly for the insights they offered into AML compliance procedures during these time periods.

⁷⁸²Dillman, D. A., & Smyth, J. D. (2007). Design effects in the transition to web-based surveys. *American Journal of Preventive Medicine*, 32(5 Suppl), S90-6. doi:10.1016/j.amepre.2007.03.008

⁷⁸³Dillman, D. A., & Smyth, J. D. (2007) p91

4.7.13.5.1 Typology Reports & Case Studies

One of the biggest challenges that the project faced was that of access to current TBML cases since these are rare at the moment, due to the relative newness of defining TBML as separate from other forms of cross jurisdiction ML activities. Gaining access to information on TBML case studies is also extremely challenging for an individual researcher, due to the nature of confidentiality and the legal implications if cases are still being processed. Certain organisations such as the national Financial Intelligence Units (FIUs), do have access to this information and have the remit to process and publish the data, in the interests of developing the banking sector.

“These observations are intended to assist with identifying instances of suspicious financial activity in the real world. It is hoped that the case studies and ‘red flag’ indicators included in this report will assist the front-line financial institutions and non-financial businesses and professions (casinos, accountants, lawyers, real estate, etc.) involved in implementing preventative measures including customer due diligence and suspicious transaction reporting.”⁷⁸⁴

These cases are presented in a sanitised format through typology reports and provide researchers with the opportunity to use real cases and analyse actual money laundering techniques that have been used.

⁷⁸⁴ APG. (2015). APG yearly typologies report 2015. Methods and Trends of Money Laundering and terrorism Financing. (P4)

The organisations that produce these reports such as FIUs or the Financial Action Task Force (FATF) have professional credibility within the banking and financial sectors including recognition by the World Bank, IMF and the UN. This was seen as important by the research because there has to be an accepted level of trust in the data being used if the recommendations are to be implemented within the banking sector, and these organisations meet that level of requirement. Alongside these groups the countrywide financial intelligence units publish completed case studies from within their specific region or country, such as AUSTRAC in Australia and Customs and Homeland Security in the US. In order to ensure both a legal and ethical responsibility to all involved, this research chose to work primarily from approved data from these recognised organisations.

Given the lack of specific TBML case studies available and in order to expand the sources available to the project, this research used examples of case studies and typology reports on both ML and TBML activities. The purpose of the typology reports was to examine sanitised case studies of actual empirical examples that had been detected within the banking system already, and would therefore provide realistic examples from which to undertake a risk assessment analysis. The main reports that were used were;

- World Bank (Pirate Trails: Tracking the illicit financial flows from pirate activities off the Horn of Africa.) ⁷⁸⁵
- APG Typology Report on Trade Based Money Laundering ⁷⁸⁶
- AUSTRAC Typologies and case studies report ⁷⁸⁷
- Methods and Trends of Money Laundering and Terrorism Financing ⁷⁸⁸ (APG, 2015)

These documents were used to extrapolate details of how actual TBML cases operated or could operate, and to determine from this how the trade financial details and irregularities might have shown up in the banking context.

4.7.13.5.2 Bank Case Studies

The media covered a number of case studies during the compilation of this research project and three of these were deemed particularly relevant to this study. The following two case studies were chosen because of their recognised association with international correspondent accounts and TBML related activity. Both cases refer to HSBC and provided a global perspective on one bank's approach to AML compliance across the globe during the time periods of 2007 – 2008 when the cases

⁷⁸⁵ Do, Q. -T., Blanc, J., Kruse, A., Le, T., Levchenko, A., Ma, L., Shortland, A. (2013). The pirates of Somalia: Ending the threat, rebuilding a nation. The World Bank Regional Vice-Presidency for Africa

⁷⁸⁶ APG. (2012). APG Typology Report on Trade Based Money Laundering. Sydney: Asia Pacific Group on Money Laundering.

⁷⁸⁷ AUSTRAC. (2014). Typologies and case studies report 2014. Australia: AUSTRAC.

⁷⁸⁸ APG. (2015). APG yearly typologies report 2015. Methods and Trends of Money Laundering and terrorism Financing. Retrieved from <http://www.apgml.org/methods-and-trends/page.aspx?p=8d052c1c-b9b8-45e5-9380-29d5aa129f4>

actually occurred and 2015-2016 when the responses from the banks and the investigation results were presented.

4.7.13.5.3 Industry Based Studies

In addition to the case studies there were a number of reports and financial surveys that had been compiled in relation to ML activities and the broader area of financial crime. These reports included the annual financial crime surveys that KPMG ⁷⁸⁹ produced for 2013 and 2014. In addition to these PwC ⁷⁹⁰ had produced a handbook based on their global survey on customer due diligence procedures and the reporting of suspicious transactions across the globe. Between these reports the organisations had accessed a large number of banking and AML compliance staff, from across the globe and findings from their reports were deemed as particularly relevant to aspects of this research.

- KPMG Annual Financial Crime Surveys (2013,2014)
- PWC TBML Guidance (2014) and Customer Due Diligence (2015).

⁷⁸⁹ KPMG. (2014). Global anti-money laundering survey / KPMG. (2013). Global anti-money laundering survey

⁷⁹⁰ PwC. (2015). Know your customer: Quick reference guide

4.8 Conclusion Methodology

The research framework was thus comprised of a number of levels as outlined in the research onion model devised by Saunders. Using this model there were six levels

- A. Research Philosophy
- B. Research Approach
- C. Research Strategy
- D. Research Choices
- E. Timescale
- F. Data Collection

The research philosophy was a pragmatic model as suggested by Robson in his work on real life research designs and incorporated an exploratory design.⁷⁹¹ In order to fully capture the range of mixed data sources available on this subject matter, the research framework used a mixed methods research (MMR) approach⁷⁹² and was influenced by work from researchers such as Mengshoel who identified many of the challenges and difficulties that were likely to be encountered using this approach. The research design finally selected to use both quantitative data in the form of a survey and qualitative data in the form of interviews. One of the challenges that Mengshoel highlighted was the need to be able

⁷⁹¹ Robson, C (2002) *Real World Research* (2nd ed.) Oxford: Blackwell Publishing

⁷⁹² Mengshoel. (2012). Mixed methods research - so far easier said than done? *Manual Therapy*, 17, 373-375

to access skills from qualitative and quantitative researchers in order to be successful in MMR research.

*“But conducting MMR seems to require broader sets of skills than needed to perform quantitative or qualitative studies alone.”*⁷⁹³

This challenge was overcome slightly by using an exploratory research design, which worked to the existing strength of the researcher. Both forms of data collection were similar in format since the on-line interview was an expanded version of the survey theme, thus the range of research skills required was manageable by one researcher.

The research used both primary and secondary data sources to ensure that the full scope of opinions and discussion on the topic were represented. Secondary data sources included other academic research as well as empirical based surveys and reports. The emphasis was on Reichertz's exploratory research design and applying an adductive approach ⁷⁹⁴ to the analysis, so that even in the quantitative survey design the focus was to explore options rather than to categorise responses numerically.

“the secret charm of abduction: it is a logical inference (and thereby reasonable and scientific), however it extends into

⁷⁹³ Mengshoel. (2012). Mixed methods research - so far easier said than done? *Manual Therapy*, 17, 3 p374

⁷⁹⁴ Reichertz, J. (2010). Abduction: The logic of discovery of grounded theory. *Forum Qualitative Sozialforschung / Forum: Qualitative Social Research*, 11(1), 12

*the realm of profound insight (and therefore generates new knowledge)."*⁷⁹⁵

4.8.1 Diversity within the research responses

This research project has always acknowledged that the social construct framework would have to encompass the variety of perceptions by experts across the fields of AML/TBML compliance. This variety was both between different persons working in the same organisation and also between different types of organisations involved in TBML investigations. In order to assess the commonalities across these different social constructs a number of data collection methods have been used, in order to develop as clear a picture of the overall AML/TBML compliance system currently operating within the generic banking sector. These methods were united in the design through the use of a Delphi approach.

4.8.2 Delphi

The Delphi methodology used by Hassen & Keeney⁷⁹⁶ was integral to the research design even at the research proposal stage. This ensured that all components of the research including the theoretical framework, access to participants and draft survey questions were reviewed by

⁷⁹⁵Reichert, J. (2010) p14

⁷⁹⁶Hasson, F., & Keeney, S. (2011). Enhancing rigour in the delphi technique research. *Technological Forecasting and Social Change*, 78(9), 1695-1704. doi:10.1016/j.techfore.2011.04.005

leading authors in the field of TBML. This was felt to be important because there was not a clear field of study e.g. banking, finance, criminology or law that held the expertise on this issue. Delphi techniques were originally developed in order to establish an informed collective opinion within a sector or “*to obtain the most reliable consensus of opinion of a group of experts.*”⁷⁹⁷ By working across the different sectors equally, it reduced the element of potential bias of including one sector claiming authority more than another, but more importantly it reduced the bias of the researcher trying to fill information gaps that might exist between the different sectors.

In conclusion, the research framework was developed using three main components which were; a Delphi approach; using mixed methods research including an exploratory triangulation process; and finally, the incorporation of a theoretical framework. The next chapter presents the data and analysis of the results gathered through this methodology framework.

4.8.3 Ethics

The research involves primary data collection from individuals and as such will need university research ethics approval. The research topic contains an element of political sensitivity, although most of the information being gathered is already in the public domain. The focus on

⁷⁹⁷ Dalkey, N, C and Helmer, O (1963) An experimental application of the Delphi method to the use of experts, *Manage. Sci.* 9 (3) 458-467.

criminal activity, AML and terrorism funding are potentially sensitive and difficult subjects and all participants will have the right to highlight information that cannot be published even if it is shared with the researcher. All participation in the research was voluntary. A specific research ethics code will be developed that can be sent along with any email correspondence as and when required.

4.8.4 Risk & Safety Assessment

The research is designed to be completed either electronically or by telephone. However, if face to face interviews or meetings had been arranged standard risk assessment procedures would be followed, including arranging to meet where possible on university grounds or public venues.

- A. The research did not interview convicted money launderers as part of the research,
- B. The research did not work with young people under the age of 18
- C. Telephone and electronic contact would be the primary source of material used and communication system in operation. A referral policy was used that stated that inappropriate material, or messages received from any research source would be referred to the appropriate member of staff within the department.

D. Details of conferences attended as part of the research were logged and accommodation details and mobile contact information left with the appropriate member of staff.

4.9 Participants - Voluntary Informed Consent

The research sought to work collaboratively with a number of other academics and industrial banking experts across the sector. As with other social research the major tenets of ethical collaboration were used such as ensuring trust and confidentiality where required. The research produced its own code of ethics for collaboration that was shared with all participants involved in the project to reassure participants especially those still working in the banking sector, that advice and insights would be treated with the utmost confidentiality. This code will outline procedures for data sharing, guidelines on authorship, confidentiality rules and data sharing policies where appropriate.

All participants in the research so far have been offered the opportunity to review the research proposal and to offer suggestions for amendment or change. Invitations were made to become members of the expert panel and also to participate in the semi-structured interview.

Participants on the expert panel were offered the opportunity to review the proposed empirical model being developed and to provide

feedback and suggestions for change before it is finalised. All experts had the right to be named or retain anonymity throughout the research project.

4.9.1 Implications for Participants Workload

The research was seeking to include experts and interested participants who are already working on this topic or have a professional interest in the subject matter. To this end participation for most people was part of their normal workload and should not therefore have become an additional burden. All participation was voluntary and reasonable deadlines were allowed to facilitate work pressures and other commitments.

Any feedback that was required was sent out by email and if experts gave feedback this was incorporated before asking for further advice or input. The research has maintained a fairly flexible approach throughout when responding to expert opinions and views. This has ensured that participants do not feel unduly pressurised or feel that an inordinate amount of time has been spent filling out information. Most feedback was in the form of suggestions and usually recommended that I checked out their thinking with other individuals first to ensure consensus where appropriate.

4.9.2 Participants Right to Withdraw

There are a number of reasons why participants might have decided to withdraw from the research process. In this research the main

reasons are; confidentiality of information and possible conflict between maintaining confidentiality at work and sharing data or information with ourselves in the project. Secondly, the secrecy component of the work and the impact on security and risk within the bank may cause some participants to review their level of participation in the project. Finally, staff and/or their workplace may decide that too much additional work is currently being carried out and some projects have to be withdrawn from.

All participants were informed of this at the start and throughout the process. In addition, there are a number of options available to participants, so that if experts need to pull back on their commitment they could opt out at any stage to only undertake an interview or to withdraw completely. The research does not depend exclusively on continued participation by everyone, nor is there any detriment to the research if participants join later on in the project, rather than at the beginning of the data collection period.

4.9.2.1 Follow Up On Participants Who Withdraw

The research was targeted at professionals and so on-going relationship and communication would be maintained throughout and before the actual research commences. This was raised with some participants in terms of distance, company rules and relevance to the research topic. These issues have been discussed through and alternative solutions that work for both researcher and participant / expert have been

agreed. It is envisaged that a similar process will be maintained throughout the research project.

4.9.3 Detriment to Participants

The research is aware of the potential political difficulties that this topic may generate for some types of organisation. The targeting of participants already engaged in the sector should ensure that at some level there has already been a thought through ethical consideration of the topic and the impact it may have on their own organisation. The research is not intending to work with anyone under 18 and has not sourced any participants currently serving jail time for crimes committed. However, if this opportunity did arise the participant would be asked to consider any legal implications that disclosing information may have on their own case.

4.9.3.1 Avoiding disadvantage to any particular group of participants

The research ensured anonymity within case study description especially detailing specific communities and individual identities. It also sought to portray a balanced global perspective on the issue of AML compliance, rather than highlighting all poor examples for one jurisdiction compared to positive cases in another area.

The research topic also covered sensitive political areas such as links to terrorism activities which had the potential to perpetuate myths associated with racial profiling. This research needed to ensure that negative stereotypes associated with particular countries and ethnic groups were not reiterated in the research.

4.9.4 Privacy

All interview responses were reported as anonymous but according to the sector represented. Interview data and identity will be known to the researcher and supervisor to ensure validity and authenticity of data. However, this information was not shared with anyone else.

4.9.5 Feedback to Participants

The research has incorporated a Delphic methodology for data analysis to ensure that expert participants have the opportunity to offer feedback and amend suggestions arising from the research. This has also been done to ensure relevance across a number of different disciplines.

Any participant included in the interview process was informed of the purpose of the research.

4.9.6 Avoiding Researcher Bias

To some extent the researcher is independent to any practitioner role within a banking context, due to the nature of separation between academic institutions and global banking institutions.

The researcher is mindful that many regulatory sources are emphatic that money laundering is a crime that has to be stopped by banks, However, this is not an opinion that is supported in every country. In many countries it is the means by which the money was acquired that is the crime not the method by which it enters the financial system. Therefore, any recommendations on future risk assessment systems would need to be mindful of the transition many banks and regulators are undergoing at the moment in order to adapt to the newer definitions and requirements of the banking role.

CHAPTER 5 DATA ANALYSIS

5.1 Introduction

The data collection and analysis section presents the results of the empirical data that was collected as part of the research study. This section explains which tools were eventually decided upon, how the participants were selected or sourced and what results came into the research for analysis. At this stage it does not try to analyse the data in too much detail, but simply presents the raw data after it has been initially sorted.

5.2 Data collection tools

The research chose two main data collection methods. These were a broad reaching survey that aimed to reach 250 participants across the globe who were all connected to AML work in the banking sector and a more detailed follow on, on-line interview with a smaller group of specialist participants.

Following on from the initial identification of issues in the literature section, the data collection tools were designed to initially include two surveys, that would collect views on the effectiveness of the current AML systems from the perspectives of

- a) Banking staff and also
- b) Individuals working within financial intelligence and law enforcement.

Opinions were sought from the expert panel on remaining gaps and/or possible areas for change from the themes that had been identified. The information from all these sources could then be compared and contrasted to findings from other secondary data sources such as international empirical surveys and research conducted from within the banking sector.

However, once the data collection phase had been completed it was decided that the information gained from the financial intelligence survey would form a separate piece of work. This research project therefore only used the primary data collected from the first survey, since this was focused specifically on risk assessment for TBML within the banking domain.

Having obtained data from a number of sources the biggest challenge for the project was to develop a framework for the analysis. This framework had to combine two different types of primary data i.e. the surveys and the interview results as well as merge the findings from the secondary data.

5.2.1 Research Questions

- How does TBML manifest within a global banking context?

- How do criminals wishing to manipulate banks for TBML gain access to the financial services they require?
- What tools are currently used in TBML risk assessment in banks, and what are the strengths and difficulties associated with these?
- What models of risk assessment/control framework can be developed for TBML?

The development of such a set of research questions was tantamount to building the foundation of my PhD thesis. A sound and valid exploratory thesis had to return to a definitive set of questions throughout its course. An outline follows of the steps taken to develop the research questions that kept the arguments, rationales, data presentations and conclusions all heading in the same direction.

Firstly, it became apparent at the underestimation made of how much time it would take to develop a set of original questions it required quite a lot of reading, legwork and contemplation. The goal for the research questions was not only that they be clear and unambiguous, but also that they provided answers that would make a substantial difference to the field of trade based money laundering.

The journey to arrive at the stage of setting on these research questions for the thesis was that firstly, it began with a processing of reading as much as possible about the fields of money laundering, trade based money laundering, banking regulation, banking risk assessments

and also taking a look at the frequent cases and fines being reported in the media in relation to these areas. It may seem to be an obvious first step but it was critical to understand intimately the existing theories, and the contemporary research, in these fields, as well as the language that was used to express them.

This led to being fully immersed in the current issues, challenges and realities of the field, and allowed for a decision to interrogate the methodologies of existing research ⁷⁹⁸ - asking, for instance, how a mixed methodology approach could benefit further research?

“Could a blend of methodologies yield alternative results, as opposed to only qualitative or quantitative data?”.⁷⁹⁹

The second step taken was almost in tandem with the first, and it was to speak to as many experts and professionals in the field of anti-money laundering and trade finance as possible. Spending time exploring actual challenges with people on the ground was invaluable, and the discussions and email communication were very beneficial to the research. It was these lengthy discussions with Industry experts, with academic experts in the subject matter, and also with supervisory staff that led to the devising of questions that all felt and agreed were such questions being settled on that were very important and equally very

⁷⁹⁸ Alvesson, M. and Sandberg, J., 2011. Generating research questions through problematization. *Academy of management review*, 36(2), pp.247-271.

⁷⁹⁹ Creswell, J.W. and Clark, V.L.P., 2007. *Designing and conducting mixed methods research*.

interesting. All parties agreed that such questions would be the most beneficial to the academic sector whilst also offering great benefit to the industry and contribute a great deal to the body of knowledge.

To build suitable foundations for a PhD thesis that could make a material difference to real-world problems was obviously preferable to one that did not. It was this that pushed the thought process in trying to uncover questions that, if answered, would be of actual interest and value to professionals in both the academic field as well as industry.

By the taking of these steps, the selection of research questions was ultimately a rewarding and useful experience. By immersing oneself in current information, it allowed for the arrival of very rewarding and exciting areas of contemplation. Regular discussions with the supervisory staff ensured the suitability and validity, from an academic perspective, of what was intended to be done.

Distilling a finite set of questions to answer, from years of intensive and dedicated study was surprisingly difficult. No fight was put up against it being hard, but worked with that initial confusion and difficulty allowing it to lead down an original and interesting path.

5.3 TBML Complexity

The first issue that was identified as problematical and which affected the analysis, was the level of complexity of the subject matter,

namely TBML.⁸⁰⁰ In particular, the challenge was to break down the different aspects of TBML into manageable themes or sub topics. This process was started initially in the literature review section and then developed so that some of the emerging themes could then be used as the framework for the data analysis coding system.⁸⁰¹

The coding system that was developed eventually for the project focused on elements of both ML and also TBML. The research examined the issues that occurred most frequently across all the papers included in the literature review. This coding approach, like the literature review section, sought to identify and isolate the different components of TBML transactions and the problems that were presented within a regulatory and banking context. The codes were developed from a cross section of both theoretical and empirical related papers.

5.3.1 Data Analysis Framework

The research analysis framework consisted of two elements, the primary data results collected by the research project itself and coded

⁸⁰⁰ "Trade-based money laundering (TBML) is a complex phenomenon since its constituent elements cut across not only sectoral boundaries but also national borders. The dynamic environment of international trade allows TBML to take multiple forms." APG Trade-Based Money Laundering Report Available at: <http://www.fatf-gafi.org/publications/methodsandtrends/documents/trade-basedmoneylaunderingtypologies.html>

⁸⁰¹ Gläser, J & Laudel, G (2013). Life with and Without Coding: Two Methods for Early-Stage Data Analysis in Qualitative Research Aiming at Causal Explanations [96 paragraphs]. *Forum Qualitative Sozialforschung / Forum: Qualitative Social Research*, 14(2), Art. 5, <http://nbn-resolving.de/urn:nbn:de:0114-fqs130254>.

against the literature review themes and then secondly coding the primary findings against the secondary research data. The research project could then analyse the findings and compare and contrast the results, in some instances against other empirical research.

The table that follows on the next page shows the research question themes and the links between the primary and secondary data sources that were to be used in the data analysis process.

These questions represented the research question themes that had emerged from the literature review and literature analysis sections. They were designed to flow towards gathering data that would lead to the eventual development of an appropriate risk assessment tool.

In order for this to be achieved the data needed to focus on developing a complete understanding of how TBML cases were being presented in the banking context and how they were currently being assessed. One of the primary questions to be answered was whether TBML needed a separate system or whether current AML frameworks simply needed to be adapted. As part of understanding the risk assessment process the research wanted to know who (which positions) within the banks were primarily responsible for AML and TBML detection since these would represent the first line of defence and require any upskilling training. The research was also interested to hear from staff where they felt additional support was needed, both in terms of resources

but also knowledge and management understanding of the problems they were working with in relation to TBML.

By combining the research knowledge of how TBML works and how criminals are currently manipulating the system, as well as understanding the criminal's motivation for wanting to move money in this way, it was hoped to match this to the systems of detection and where necessary suggested amendments to strengthen the process. As a result, the research questions considered four areas of knowledge that needed to inform the final proposed risk assessment framework;

The four areas that were used were :

1. Understanding TBML activities
2. Criminal motivation to change techniques or use certain approaches
3. Reporting compliance requirements and
4. Risk assessment strategies to capture information.

Table 3: Summary of research questions and primary and secondary data sources

Research Question - summary	Data Source Empirical Primary	Secondary Data
Q1 What is TBML, what does it look like?	Case study reports Semi-structured interviews	Crime survey
Q2 How do criminals launder money?	Typologies of TBML activity Semi-structured interviews	Financial Services reports Journal articles
Q3 –Operational Risk Processes -Suspicious Activity Reporting info (SARs) Customer Due Diligence Enhanced Due Diligence	Semi-structured interviews HSBC case study	KPMG report AML experts Journal article analysis IIA Guidelines FSA Reports
Q 4 - What frameworks can be developed	Case studies TBML Semi-structured interviews	Journal Articles

* The table shows the research questions and both the primary and secondary data sources available that can be used to answer each question

5.4 TBML Typology Framework

As part of the analysis process a TBML typology tool was developed. This model is an adapted risk matrix focusing on client behaviour that will be used to classify TBML activities. It differs from an ordinary risk matrix in that there is also an inner circle, in which neither the client behaviour nor the transaction activities might be identified as high risk, but together they pose an increased threat. Activities for example such as the purchase or shipment of 'dual purpose goods' i.e. items that could be used for either legitimate as well as illegal/terrorist purposes including computers or electrical hardware goods. Other low risk indicators that could escalate to high risk very quickly might also include the following:

- A. Clients shipping goods through free trade zones where custom inspections are less stringent.
- B. Legitimate businesses used as TBML fronts.
- C. Clients changing business partners or establishing new types of business.
- D. Clients working in high risk countries or countries known for risks of bribery and corruption.

These techniques are also used for other criminal activity such as VAT and tax fraud so developing a strong risk assessment framework is important and can be applied across all techniques.

The research is particularly interested in identifying potential escalation zone activities which could traditionally be categorised as low or medium risk, and therefore do not trigger any red flags by themselves. The aim is to develop a model that builds on information as and when it emerges or is investigated. This will hopefully ensure that only high risk profiles are reported as a SAR, rather than large numbers of transactions being reported without being systematically risk assessed.

5.4.1 Coding the Data

Coding data has been used in interpretive and qualitative research designs for a long time, dating back as far as the 1960s and the work of Glaser and Strauss.⁸⁰² It was used originally in many grounded theory approaches, whereby the research theory emerged from the data analysis. This approach has become more popular with social scientists such as Robson⁸⁰³ trying to work in real life scenarios rather than laboratory settings. In more recent studies such as work by Glaser and Laudel coding can be used in a number of different ways including using it alongside pre-

⁸⁰² Glaser, B. G. & Strauss, A. L. (1967). *The discovery of grounded theory: Strategies for qualitative research*. Chicago, Ill: Aldine

⁸⁰³ Robson, C (2002) *Real World Research* (2nd ed.) Oxford: Blackwell Publishing

existing theories and incorporating different mechanisms for coding themes to coding content.⁸⁰⁴ Coding generally therefore is about indexing segments of text and classifying it in some order.

“The core idea of coding is that the texts containing the raw data are indexed. Codes— keywords, phrases, mnemonics, or numbers—that signal the occurrence of specific information are assigned to segments of the text.”⁸⁰⁵

In grounded theory approaches according to Glaser & Strauss, no pre-existing literature theory should be used. Instead the grounded theory data should reveal the appropriate theoretical model. However, since most observations are themselves influenced by theory⁸⁰⁶ and many qualitative researchers have already dismissed positivist observations for being value laden, then theory has to play some role in the analysis and development of codes. This is reiterated in the following statement.

“They thereby deprive researchers of the most important function of prior theory, namely that of a source of (comprised, abstracted) information about the empirical

⁸⁰⁴ Gläser, J & Laudel, G (2013). Life with and Without Coding: Two Methods for Early-Stage Data Analysis in Qualitative Research Aiming at Causal Explanations [96 paragraphs]. Forum Qualitative Sozialforschung / Forum: Qualitative Social Research, 14(2), Art. 5, <http://nbn-resolving.de/urn:nbn:de:0114-fqs130254>.

⁸⁰⁵ Gläser, J & Laudel, G (2013, p10)

⁸⁰⁶ Gläser, J & Laudel, G (2013)

object of their research, which has been collected by their colleagues in previous research.”⁸⁰⁷

5.4.2 Qualitative Data Analysis

One option that could have been used instead of coding was a qualitative data analysis approach, which is similar to coding in that it reduces the amount of data and summarises the key points into themes and topics. Although qualitative data analysis and coding can appear quite similar there are a number of differences, qualitative data analysis tends to reduce the data by replacing the original text with an abbreviated and shorted version, coding however, retains a link to the original content.⁸⁰⁸ This latter point was believed to be important to the researcher as a means of ensuring consistency in the interpretation of meanings, so that the original text could always be referred to.

“If at any later stage of the investigation the actual phrasing of a significant part of the information is important, coding and retrieval procedures are better suited because they offer better access to the original text.”⁸⁰⁹

⁸⁰⁷ Gläser, J & Laudel, G (2013, p10)

⁸⁰⁸ Gläser, J & Laudel, G (2013). Life with and Without Coding: Two Methods for Early-Stage Data Analysis in Qualitative Research Aiming at Causal Explanations [96 paragraphs]. Forum Qualitative Sozialforschung / Forum: Qualitative Social Research, 14(2), Art. 5, <http://nbn-resolving.de/urn:nbn:de:0114-fqs130254>.

⁸⁰⁹ Gläser, J & Laudel, G (2013, p23)

5.4.3 TBML Research Coding

The qualitative data responses in this research were coded and themed using the qualitative data analysis software HyperRESEARCH.⁸¹⁰

“HyperRESEARCH is a HyperCard-based application that allows for qualitative and quantitative analysis of textual, graphic audio, and video materials. HyperRESEARCH performs the following tasks: (1) The coding of text (of any length: a word, phrase, sentence, paragraph, etc.), graphics, coding of audio, video tapes using Tandberg computer controlled tape decks and several types of computer controlled video systems (video disc and video tape). A given segment of text, graphic, audio and video can be assigned multiple codes. (2) Retrieval of coded materials (text, graphics, audio and video segments) enabling the researcher to array all similarly coded material together. (3) The testing of propositions by performing Boolean searches on any code or combination of codes via the use of an expert system. (4) Hypothesis testing using artificial intelligence. The Expert System software technology uses production rules to provide a semi-formal mechanism for theory building and description of the inference process used to draw conclusions from the data. (5) A statistical option which

⁸¹⁰ “Hesse-Biber, S., Dupuis, P. and Kinder, T.S., 1991. HyperRESEARCH: A computer program for the analysis of qualitative data with an emphasis on hypothesis testing and multimedia analysis. *Qualitative Sociology*, 14(4), pp.289-306.

allows for the simple analysis of coded data. The use of HyperRESEARCH as a methodological tool supports important advances in the validation, reliability and generalizability of qualitative data analysis.”⁸¹¹

This software enabled the researcher to build up a bank of codes and to link the main themes as they emerged, to each of the research questions. In particular, the research sought to identify patterns of both client and transaction behaviour that could be useful to developing a risk based assessment strategy. The analysis also considered any emerging potential weaknesses in the current AML and risk assessment systems.

5.4.4 DATA RESULTS

This section of the report presents the findings from both the primary and secondary research data sources. For the primary data this is primarily the online survey results for TBML and the financial services, as well as the follow up interviews with TBML and AML experts across the sector. The secondary data findings include the review of industry based publications on TBML and AML compliance. It also includes the extraction of data from interview reports undertaken in the media or business magazines with AML experts, in response to several banking investigations that have occurred during the course of this research project. The final source of secondary data that has been used in the

⁸¹¹ Ibid.

research, is in the form of industrial experts such as external accountancy companies and AML compliance training companies. The research has utilised the booklets and guidelines that have been published and which represent their opinion of how AML and TBML detection should occur in the future financial services sector.

5.5 Financial Services Survey

The data collected from the TBML financial services survey was representative of most of the main divisions of the financial services sector. Including forensic audit and external audit. In total 29% of all responses were not directly from the banking sector including audit and regulatory bodies, with the remaining 71% from the banking trade finance sections, AML Business Management and Internal Audit units.

The survey consisted of 14 questions that focused on four broad areas of TBML detection within any organisation and which were of interest to the research project questions. The areas are listed below;

1. General background including the percentage of time spent on AML.
2. The detection of TBML within the organisation, how it was detected, which staff positions were responsible and whether it was recorded separately to other AML threats or risks.

3. The link between TBML and Internal Audit functions within the organisation
4. The approach and culture of the organisation towards TBML detection, including links to governance and identifying factors that currently impede detection.

5.5.1 Background of AML Respondents

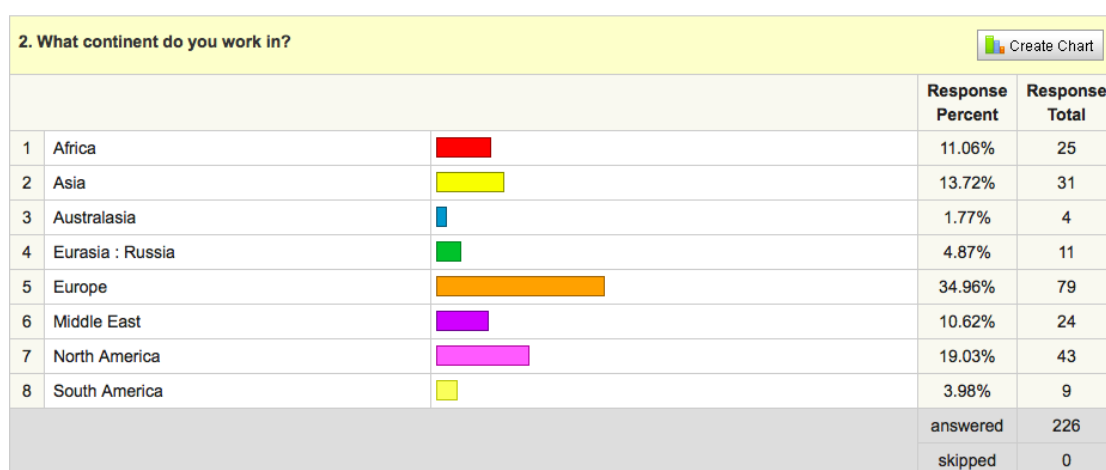
A total of 256 respondents took part in the online survey aimed at AML and TBML experts within the banking and financial services sector. Of these a total of 226 responses were deemed to be complete and able to be used in the research project.

5.5.1.1 Countries Represented In the Research.

The research was interested in attaining views from across the global banking sector. Since AML compliance is a global response it was felt important to get a representative picture from as many countries as possible. Also as TBML involves the movement of value across international borders there would be little point interviewing a few select countries and not having representation from the countries at the other end of the shipping transaction.

In total 58 countries were represented in the survey with 226 completed questionnaires. There was a good spread of responses from across each of the continents even if individual country responses were lower due to the specialised nature of the topic.

As a continent Europe had the largest return at nearly 35% followed by North America (19%), Asia (13%), Africa (11%) and the Middle East (10%).



The survey was distributed across a broad range of the financial services sector, although responses were more forthcoming where prior connections were already in existence.

The spread of countries was seen as beneficial because the research was viewing AML regulation as a global issue and the literature had suggested a move towards international standards, however, this meant that the return per country was quite small. If there had been a strong level of diversity in their responses this might have proven

significant, but as most countries are implementing international standards and all are reporting to FATF, then the overlap was probably quite strong.

In other words, national TBML / AML strategies have largely been superseded in favour of an international response, given the international nature of the criminal activity. As such the research needed to also work from this international perspective especially since the findings would need to be reported back to international bodies such as FATF, the International Banking Federation and international business schools across various universities.

Although there was a strong international representation the research was also mindful that some countries have been further ahead in addressing AML compliance than others. Perhaps the two countries that have seen clear changes and advancements in AML compliance and monitoring have been the United Kingdom and the United States. We had as strong representation of responses from both these countries (13% and 12% respectively), which was viewed as being beneficial to the research data.

5.5.2 Sector

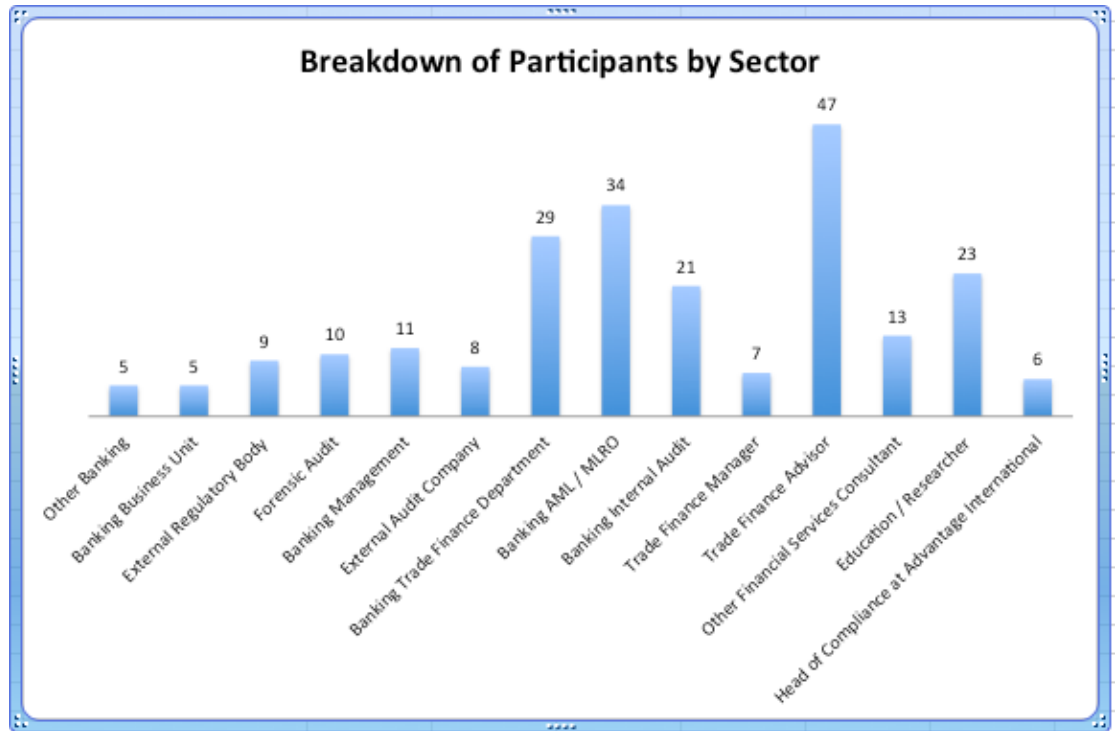
The graph on the following page shows the representation of the respondents according to sector. It had been the main interest of the research to hear from staff working directly on risk assessment for TBML

transactions and to capture first-hand the difficulties and challenges that they were facing along with examples of what was working well.

The nature of banking meant that according to the size and location of the bank different roles would perform different functions, and this applied especially to the detection and reporting of AML concerns. There was also an issue that since TBML was a newer issue and required some level of trade finance knowledge, would it be considered an AML or a Trade finance issue. The levels of seniority were also difficult to capture because a senior manager of a small branch may have less responsibility than a MLRO in a larger bank, in relation to TBML monitoring and reporting. Instead the breakdown of participants was done according to their role within the organization.

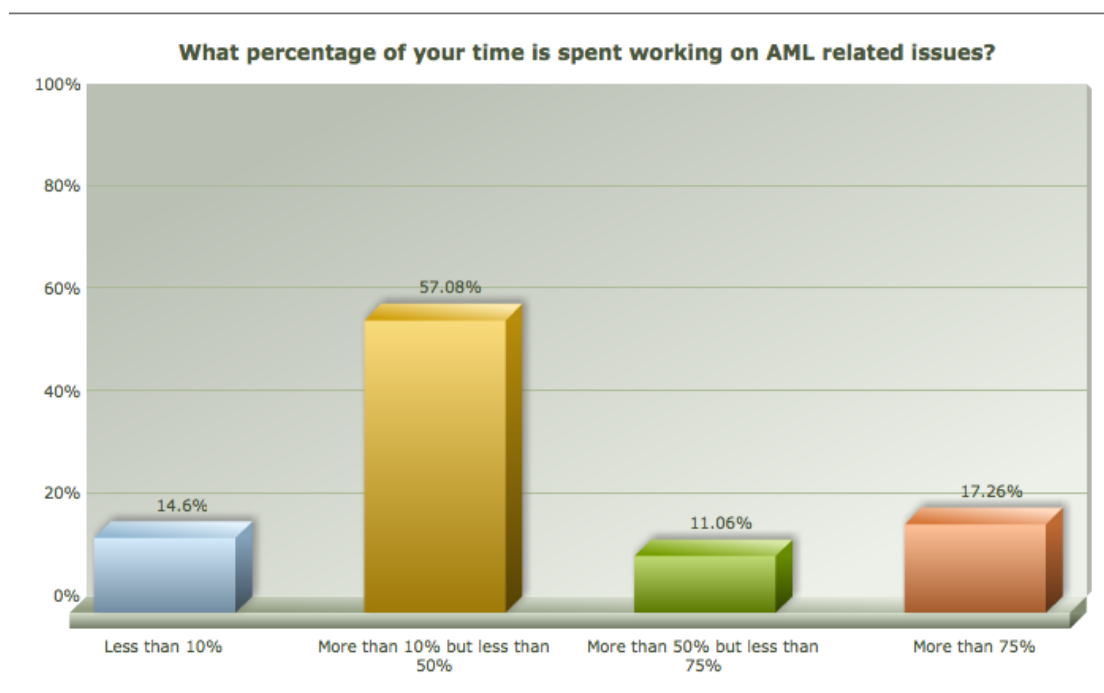
As a result, 35% of the respondents were from the trade finance department, this was further broken down in banking trade finance dept. (29), trade finance advisors (47) and trade finance managers (7).4% were from the general business unit, compared to 15% that were directly from Banking AML. Other replies came mainly from audit sections including external (8), forensic audit companies (10) and internal audit from within banking (21). The regulatory sector was also invited to reply and gave 4% of the replies (9 replies) along with banking management (11).

The final breakdown of all replies can be seen in the chart below; the numbers represent the actual number of respondents.



5.5.3 Percentage of Time Spent On AML

The final question in the background section asked for an estimated time spent working specifically on AML compliance issues. There were set options to choose from and the replies were classified in the diagram below.



It can be seen from these results that 17% of the respondents work on AML issues for more than 75% of the time, with a further 11% working between half to three-quarters of their time on AML related issues. The largest percentages of replies were from the less than fifty percent percentile.

These results reflect the literature findings that resources for AML are not always available especially in smaller banks where staff may have multiple functions to perform. The question did not ascertain what other work these staff did but given that 50% of respondents were working in trade finance or business units it is to be expected that most were dealing with risk assessment of TBML if and when it occurred in their everyday client transactions, rather than specifically looking for TBML across all clients on a full time basis.

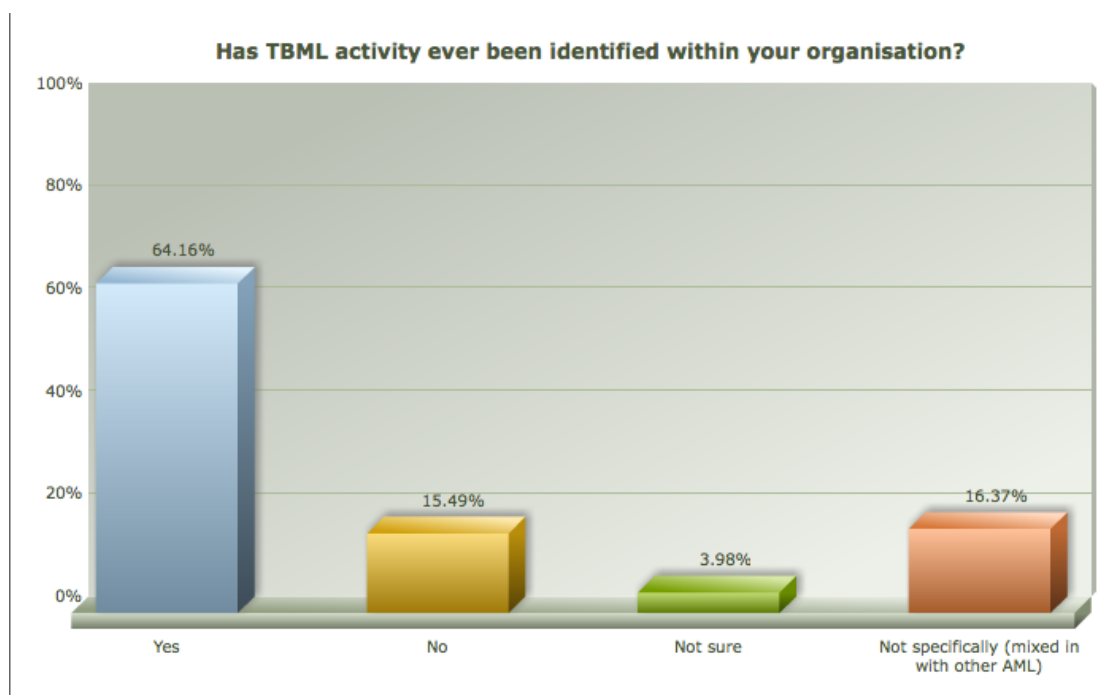
Only 14% of replies were from people who spent less than 10% of their time on AML related issues.

5.5.4 TBML Risk Assessment

The next section of the survey focused specifically on TBML detection within the organisation. The first question asked whether TBML had actually ever been identified within their organization.

It was interesting that 64% of the replies stated that TBML had been detected in their organization, because this was a clear indication that we were speaking to the correct target audience.

In line with the literature findings not all banks differentiate between TBML and other forms of ML activity and 16% acknowledged that this was the case in their bank.



In addition to the resources and overlap in roles many respondents reported that in fact nearly 63% reported that it was not recorded separately from AML with a further 26% saying it was sometimes or they were not sure as to its exact recording.

5.5.4.1 Methods Used To Detect TBML Activity

TBML was not necessarily recorded separately in their organization.

Despite the anomaly in how TBML activity is recorded the next question focused on the methods used to detect TBML activity. Respondents were given a list of responses and a final 'other' option. It was also a multi-response question so more than one option could be selected. The five main techniques that were used were;

- Suspicious Transaction Activity - 92%
- Suspicious Client Behaviour - 66%
- Customer Due Diligence (CDD) Checks - 78%
- Beneficial Ownership information 46%
- Enhanced Due Diligence (EDD) Checks - 40%

These tools would have been identified in the literature section as the main AML techniques used to establish AML risk in all areas of banking activity.

Other options that could have been used included using trade databases, having reports and links with customs and excise and geographic risk profiling.

Only one organisation out of 67 cited that they used pricing of goods as a means to detect possible TBML activity, although this would be one of the main ways that TBML activity can be spotted if used in conjunction with suspicious transaction and customer activity.

5.5.4.2 Main Person Responsible For Detecting TBML

The final question in this section asked who in particular was responsible for TBML detection within their organisation. A list of options was provided which covered the main front office and AML compliance staff positions, and a final option of 'other' was also provided. It is acknowledged that all staff have a responsibility but this question asked

who was primarily responsible. The main person identified was the money laundering reporting officer (MLRO) with 80% of responses stating that this was the key person responsible along with another AML staff member (63%).

In 10% of the cases the respondents identified another person who held primary responsibility for TBML detection within their organisation. In many cases this was a fraud or forensic accountant or another specialized position that was used to analyse trade and business transactions. This obviously depends on the resources available and for many smaller banks in particular, this level of knowledge may only be available on a sub contractual basis.

It would appear that for most financial organisations TBML is still deemed as part of the overall AML compliance structure and it is primarily the duty of the MLRO to work on TBML cases as well as other forms of money laundering activity.

5.5.5 Risk Assessment

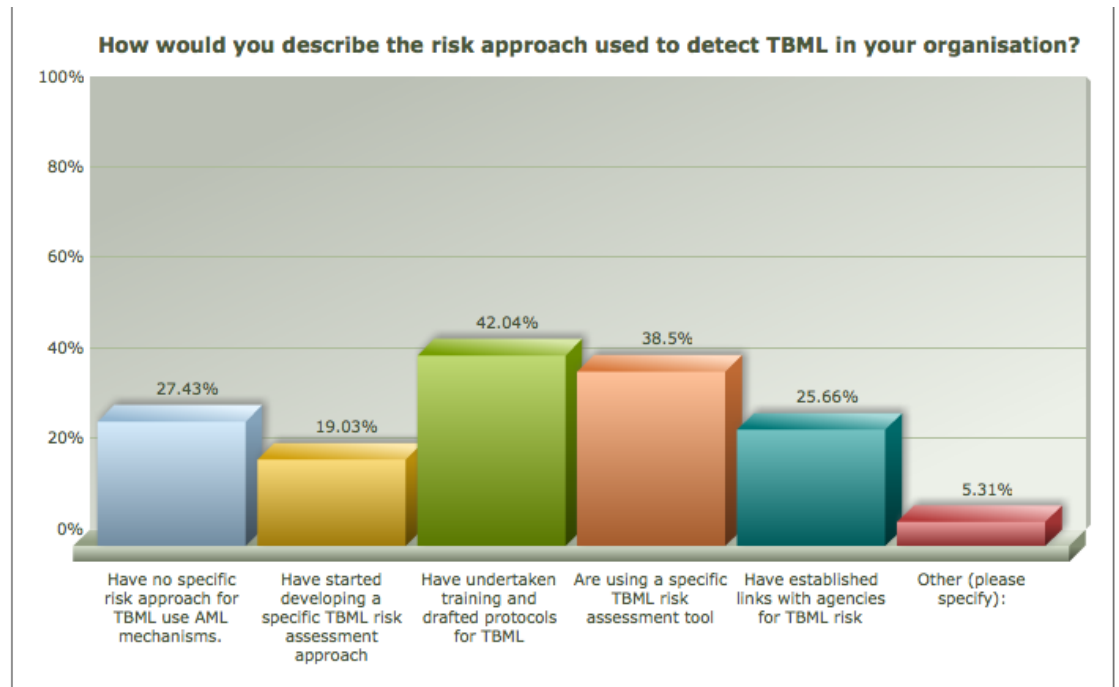
Risk Assessment is the main process by which TBML risk is uncovered by any organisation, and the research was interested to know how risk was assessed specifically for TBML. In the next step of responses, the focus was on the risk assessment process being used and the identification of strengths and weaknesses within that system.

The first question asked about the specific process used to assess TBML risk and whether or not this was separate from the overall AML risk assessment approach. Respondents could choose multiple answers although most of these would only apply if they were actually using or developing a separate TBML tool.

42% of the replies stated that they had undertaken training in specific TBML risk approaches and 38.5% had developed a specific TBML risk assessment tool, whilst 19% had started the process of developing a specific TBML risk assessment tool.

25% of respondents said that they had also developed links with external agencies in relation to TBML detection and risk assessment.

The remaining 27% of the respondents stated that their main system for TBML risk analysis was the same as their general AML risk system, and it could be assumed that they were not therefore developing a separate TBML tool.



One organisation under the 'other' category stated that they used an integrated AML/CTF and TBML risk assessment tool and another stated they used a risk based audit plan, Finally, one group stated that their integrated approach included CDD checks, so some answers could also be included in the main results as well.

5.5.6 Internal Audit

The previous questions highlighted the role that forensic and fraud accountants play in AML detection. Some of these services are external to the bank but within the bank there is also an internal audit system, which acts as one of the bank's lines of defence against money laundering activity.

The research project was particularly interested in the role that internal audit currently plays in relation to supporting and auditing AML compliance and risk assessment. Respondents were asked to define the nature of the relationship between internal audit and AML/TBML compliance within their organisation, and to choose one answer only from a number of set responses.

The following replies show;

- Some level of co-operation – 34.5%
- Seeking to develop a more coordinated audit plan – 22.6%
- A limited working relationship – 18%
- No link at all 11%
- Very close and strong working relationship – 8.4%
- (Other 5%)

In the interview responses this question was developed further to explore how participants felt that internal audit should interact and support the AML compliance units in the future.

It was clear from the results that if internal audit and AML are to support one another, there is still a long way to go with only 8% of the respondents stating that they had a very close and strong relationship between AML compliance and internal audit. In contrast 11% of the respondents stated that there was no working relationship between the two sections and a further 18% said there was only a limited working relationship.

However, 57% of the replies did report that progress was being made to strengthen the relationship and integrate internal auditing and AML compliance systems to better support one another. Since both units are collecting information that could be useful to each other it would make sense that there continues to be development in linking these two units

The challenge to this approach is the risk of compromising the perceived independence of the internal audit system. In the 'other' category which represented 5% of choices, many of the options sought instead to define internal audit and emphasise its independence from AML compliance. The following comment surmises many of these responses.

“The internal audit should assess the adequacy of AML compliance and identify any deficiencies so of course there needs to be an integrated working relationship.” (ID Participant 2)

One of the participants sought to explain the distinction between IA and AML compliance in more detail.

“They have different scope of activities: AML are responsible for setting rules, reporting, communication with authorities and collecting AML data (from both internal and external sources), audit are responsible for examining whether the rules are observed and the activities performed (including examination of AML themselves and compliance of the AML procedures applied with external regulation).” (ID Participant 10)

Overall there appeared to be a clear distinction between the two roles although again internal audit could sometimes be seen as simply checking that AML compliance was following the rules.

The research respondents however focused less on areas of collaboration between AML compliance and IAF. This would be important to consider since both departments are data driven, and it would make sense that the development of AML data collection tools and the analysis

of risk assessment strategies and tools were developed together. This would mean that internal audit can measure the actual effectiveness of AML rather than simply ticking boxes that state that systems and protocols are being followed. IAF thus has the potential to become a second pair of eyes to support the efforts of AML compliance by analysing the efficiency and relevance of the overall AML system, whereas AML compliance will be more focused on the individual components and linking them to specific ML schemes.

5.5.7 Improving TBML Detection

The survey asked two questions in relation to TBML detection, the first was what would be needed to improve TBML detection within their organisation and the second asked what was currently impeding TBML detection within their organisation. The first set of responses outlines the improvements that are needed, these were provided as a multi-choice list of options (so participants could tick more than one response) including an 'other' category

1. Additional Training in TBML for AML officers - 84%
2. More communication on TBML across the organisation - 76%
3. More training for front office staff - 43%
4. Internal audit more involved - 17%
5. Stronger communication to management - 31%

Under the 'other' option one respondent also suggested installing the SWIFT SANCTION system to add information on suspect client transactions being made to other financial institutions.

A total of 7% respondents clicked the 'other' option however some of these were just to say all of the above, other suggested greater awareness of trends in the sector and one response suggested greater automation of the systems. Finally, one respondent questioned why internal audit was mentioned implying that they did not see the link between TBML detection and audit involvement, so clearly auditing and AML are not being used together in some banks at all.

5.5.7.1 Impediments To TBML Detection

The impediments question sought to clarify whether or not a need existed for changes to be made in the TBML risk assessment and detection process of the respondent's organisation. Five options were provided in a multi answer format, with an additional 'other' option.

1. Inexperience in TBML by front office staff - 55%
2. Lack of training in TBML- 77%
3. Lack of communication on TBML to management - 57%
4. Lack of resources - 52%
5. No links with internal audit - 5%

In the other responses one reply mentioned the lack of efficiency within the regulatory bodies. Another raised the problem of an overall lack of industry intelligence whilst two other suggestions mentioned lack of knowledge of the client's business activities was a challenge and the time and complexity of transactions made it hard to monitor everything.

5.5.8 Governance

The research applied the assumption that most risk assessment models for AML involve a link to management at some level, whether this is in the form of reports through the audit committee or reporting directly to management itself. In order for this process to be as effective as possible good lines of communication between AML compliance and management or audit committees are required, as well as an openness by the different levels of the governance structure to hear an honest appraisal of the AML system in operation. The next two questions on the survey focused on asking about the current communication process and the overall corporate cultural attitude towards AML compliance, within the respondent's organisation.

The question asked 'how aware are senior management about TBML within your organisation?' Five options and the 'other' option were available. The answers are shown below in descending order of responses.

1. Know the basics –56%
2. Aware through audit committees – 22%
3. Have a good practical awareness and actively seek further knowledge - 27%
4. Very aware and practice in implementing new approaches - 5%
5. Not aware at all - 10%

Only 10% of organisations claimed that their senior management structure had no awareness of TBML issues, with the remaining responses illustrating that TBML is recognised at some level. The overall picture indicated that a basic level of awareness was there at senior management in more than half of the institutions but that more information was needed probably through further training

The second question in this section asked ‘would you consider that TBML compliance is firmly embedded in your organisation?’ Five options were again provided with an additional ‘other option’ for organisations to write their own point if required. Again the results are presented in descending order according to the number of responses, (note percentages have been rounded to the nearest whole number.)

1. No but progress is being made - 52%
2. Most of the organisation but not quite all yet - 6%
3. Definitely not - 12%

4. At least half of the organisation would have a good understanding - 20%
5. All very aware and proactive in implementing new approaches - 3%

From the 'other' responses there was a level of vagueness about the level of compliance in AML across the organisation.

1. Concerned people have a good understanding
2. Based on what we see in the market
3. AML procedures generally are compliant
4. Sectors are mandated to be fully aware of the specific AML challenges.

5.5.9 Suggestions for Moving Forwards On TBML Detection And Compliance.

The final question in the survey was an open-ended question and asked for suggestions to improve TBML compliance and detection within their own organisation. The following responses have been summarised under the following themes.

Table 4: Summary of suggestions directed towards improving TBML compliance.

Theme	Suggestions	No responses
Training and awareness of TBML	<ul style="list-style-type: none"> • Training and greater awareness • More TBML training • Use of e-learning to get this known • Include TBML case studies • KYC • In-house training to reduce training costs • Cross border training on AML gaps between jurisdictions • All employees need awareness • In house awareness • Raising awareness of the risk that TBML poses • Educational training 	22

	<ul style="list-style-type: none"> • More regional examples • Front office staff training key to detection of TBML (2) • Needs expert knowledge • Is a new concept for banking sector 	
Model examples / Typologies	<ul style="list-style-type: none"> • Greater information sharing of 'war stories' by FIUs • Keep abreast of typologies from FTAF • Live and relevant examples • Regular internal meetings to discuss possible scenarios for ML activity 	4
Software	<ul style="list-style-type: none"> • The use of International Trade Alerts software • Use of Analytic tools such as iDETECT • Audit access to treasury systems • Comparison of trade prices 	4
Audit	<ul style="list-style-type: none"> • Requires deep understanding of trade finance, often hid deeply -needs auditing experience 	1
Governance	<ul style="list-style-type: none"> • Senior management acknowledge that TBML is a risk • Firmly embed AML awareness culture across organisation • Strengthening knowledge flow at international level amongst peers 	6

	<ul style="list-style-type: none"> • Communication • Clear AML policies understood and developed at top management • Head office develop a specific TBML cell 	
Risk management	<ul style="list-style-type: none"> • Use of credit risk vectors • Still researching issues at this stage • Risk based approach peer review • Use of SWIFT • Need understanding of trade finance in risk management • Lack of integrated detection systems 	4
External factors	<ul style="list-style-type: none"> • Increased prosecutions for TBML crimes • Limit trade based activities • Registration of companies and beneficial ownership details available • Emphasis on enhanced CDD and KYC in other institutions • Need specific guidelines developed • Letters of Credit that are independent and have all documents checked • International approach across all banks • Specific government legislation needed on TBML 	8
Resources	<ul style="list-style-type: none"> • Small company therefore cannot spend time 	9

	on TBML <ul style="list-style-type: none"> Resources not enough 	
Other	<ul style="list-style-type: none"> Needs industry shakeup towards TBML 	
No suggestions	No	168

* Showing final response to the questionnaire - open-ended what needed to change in TBML detection

The results illustrate that most respondents had very few suggestions for trying to improve TBML detection, both within their own organisation and also at a wider level. However, where suggestions were made most were for additional training and educational awareness, which was the prominent focus including the need to include relevant and up to date typologies. The training also needed to be targeted across all levels of the organisation and especially aimed at front office staff. There were also suggestions to make greater use of in-house training options, including holding staff meetings to specifically explore TBML scenarios specific to the local context. The in-house approach was also seen as more cost effective rather than constantly relying on external companies.

The use of IT and software was mentioned by several respondents especially gaining access to larger databases that may contain trade related information. Several replies also made comment on the complex nature of TBML and the need for multi-level responses including management, front office and stronger links to AML compliance.

5.5.10 Concluding Observations on the Survey

The issue of TBML is still relatively new for some especially smaller organisations. One comment that highlighted this was the following;

“until I had this survey I was unaware completely of TBML”

(Respondent 37 - non banking)

Although some of the respondents represented outside agencies or audit companies with links to the banking context, most replies were directly from staff working within the banking sector. A common trend across all the respondents seemed to be the link between the size of the organisation and their ability to address TBML. Part of this was no doubt due to restricted access to resources, including expertise in TBML, staff time as well as investment opportunities into software systems and risk assessment for many smaller firms and bank branches.

Some respondents claimed that TBML was not an issue although some would be highly vulnerable, as products such as life insurance is a common money laundering vehicle.⁸¹² It also highlights the reality that it is the banking sector that will often be the first place that starts to ask these in-depth AML questions and that they cannot rely on smaller client and

⁸¹²Lawrence, S. (2008). Money laundering in the insurance sector. Aisaninsurancereview. Retrieved from https://www.world-check.com/media/d/content_pressarticle_reference/aisaninsurance_08.pdf

partner businesses investing the time and resources required in order to TBML proof their own company.

5.6 Interview Analysis

The interviews provided part two of the data material and as part of this process the survey themes were expanded into a further 8 interview themes, which covered the main topics raised in the online survey. The purpose of the interviews was to try and establish what level and type of information banks needed in order to develop strong risk based approaches on TBML assessment.

These questions were given to a sample of AML experts with experience or exposure of working directly on TBML issues within their own bank. Experts were selected using the Delphic approach, and a total 56 experts completed the questions, from across the globe, with some using phone interview and others by email in order to facilitate time zone differences. A final 50 valid answers were used in the research. The 8 interview question themes were;

- A. Background details and company
- B. Main weaknesses in TBML detection
- C. TBML too much for the banking and financial sector?
- D. Areas to strengthen in TBML risk assessment

- E. Link and role of internal audit in TBML risk assessment
- F. Use of external training agencies within banking and financial services for TBML training
- G. Investigation work in banks and financial services - how realistic is it for staff to undertake?
- H. Any other issues relevant to TBML that this research should be considering?

The questions were worded as follows;

1. What would you consider to be the main weaknesses or gaps in TBML risk assessment as you see it within the banking sector?
(Can you give any practical examples or highlight any current problems or cases we could read)
2. Is TBML risk compliance a step too far for many banks - especially as many appear to be struggling to cope with the average AML compliance (according to FCA, 2013).⁸¹³ If yes why and if no why not?
3. Where do you think the focus should be to strengthen banks TBML risk assessment, is it...
 - a. further training and who needs to be trained?

⁸¹³FCA. (2013). Banks' control of financial crime risks in trade finance. TR13/3 Thematic Review

- b. increased resources and where should they be - staffing, training, appointing specific designated TBML officers, management upskilling?
 - c. increased engagement by governance, audit committees, board of directors, management?

- 4. The research is interested in determining whether internal audit plays a role in TBML risk assessment and if so what should that role be?
 - a. Is it purely oversight and other sectors of the bank put together the risk assessment?
 - b. Do they jointly develop the risk assessment approach alongside AML and management?
 - c. Do they have a role to develop a specific AML / TBML report for the audit committee and management?
 - d. Should they routinely audit suspicious activity reports and follow the trail to assess the effectiveness of risk assessment tools and not just comment on their presence?

- b) -Are there other roles that internal audit could play in TBML detection and compliance?

- 5. Various outside agencies have developed training on TBML, what is his opinion of banks engaging with outside training organisations that work across all types of financial services?
 - a. What should be contained in this training?

- b. Who should be attending this training?
- 6. Should banks be taking on a stronger investigative role into client behaviour, beneficial ownership and transaction details?
 - a. Does this contravene the confidentiality and trust that clients have in banks?
 - b. Does it infringe too much on client's right to privacy?
 - c. Do banks have the skills to do this type of work?
- 7. Are there any other questions or issues that we should be asking about in relation to TBML and the banking sector?

5.6.1 Thematic analysis of the Interviews

The results of the interviews were analysed using the software HyperRESEARCH, which is a qualitative research analysis tool.

“HyperResearch is a qualitative research program that helps with coding and retrieval, building theories, conducting analyses of data, and testing hypotheses. Some of the program's strengths include the ability to use multimedia such as, text, graphics, audio, and video data. Furthermore, it has comprehensive code-and-retrieve functions, the ability to create code groups, flexible auto-coding, and create a code map. It also has the capabilities to assist with theory

building, while having the ability and function to add memos with annotations and citing to sources or codes, as well as, serves as an effective database management system.”⁸¹⁴

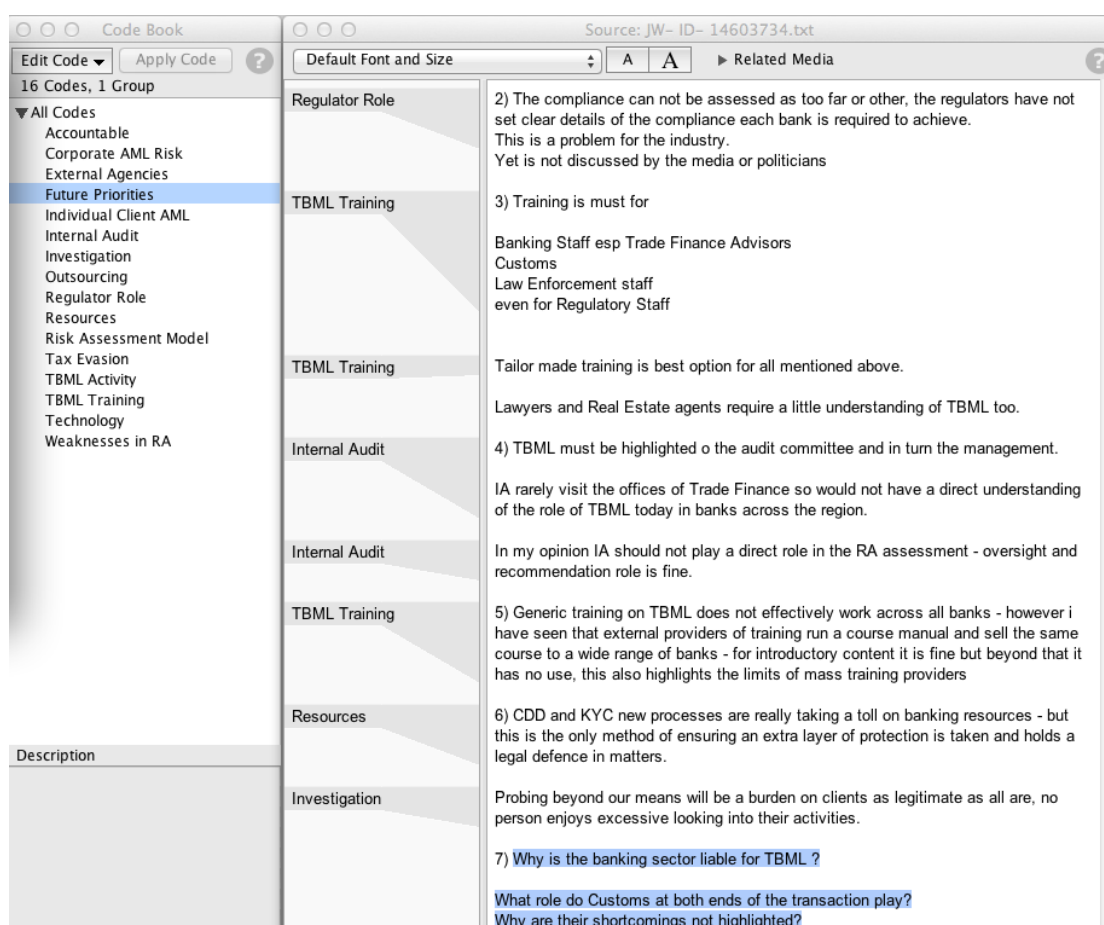
Each interview was first transcribed onto the online smartsurvey tool, which also provided an option for interviewees to fill in the questionnaire online if telephone contact was too difficult to arrange. Each respondent was allocated a computer code through the smartsurvey form and the answers were then cut and pasted into a separate text file, ready for the HyperRESEARCH software programme.

A thematic analysis approach was used whereby codes were allocated as they emerged during the analysis process. The software enabled easy coding and report generation, so once the data had been entered reports could be compiled showing all the comments under each coded theme. The ID number off the smart survey site was used as an identifier.

⁸¹⁴ “HyperResearch is a qualitative research program that helps with coding and retrieval, building theories, conducting analyses of data, and testing hypotheses. The overall analysis included a hybrid model of precoding and coding that used inductive and deductive analysis, which accounted for general domains that led to more content specific concepts that connect to the conceptual framework (Miles & Huberman, 1994). For example, Miles and Huberman (1994) preferred creating a “starting list” or precoding derived from a conceptual framework, which is deductive, but also described two other useful methods of coding, which lead to the uncovering of questions that relate to a specific area of research (p. 58). Similarly, Charmaz (2006) said a conceptual framework “provides starting points” for looking at data but “do not offer automatic codes for analyzing these data” (p. 68).” Dr. Jeffrey Glogowski available at: www.discoverthought.com/Vipassana/Data_Analysis.html
Miles, Matthew B., and A. Michael Huberman. "Qualitative data analysis: A sourcebook." Beverly Hills: Sage Publications (1994).
Charmaz, K., 2014. Constructing grounded theory. Sage.

A sample screenshot is shown in the image below where you can see the imported text file on the right with all the questions answered. On the far left of the screen is the code sheet.

As text is highlighted it is allocated a code, which can be seen in the middle pane.



In total 16 different codes were identified through the analysis process before any amalgamation or linking occurred. These were;

1. Accountability & governance implications
2. Overall corporate AML risk of the bank

3. Relationship with external agencies re TBML issues
4. Individual client AML issues
5. Internal Audit
6. Role of investigation in banking
7. Use of outsourcing (audit or training)
8. Role of the regulator in TBML compliance and support
9. Resources
10. Risk assessment model being used
11. Weaknesses in RBA
12. Tax evasion
13. Examples and problems with TBML activity
14. TBML training
15. Technology and future technology needs
16. Future priorities

A report was generated through the analysis software, which listed all the comments under each theme. This was then used to manually group together recommendations or observations that the interviewees made on each topic.

Finally, the 16 themes were then grouped together into larger clusters for reporting purposes, this was done according to relevance and relationship of the answers to one another. The final areas of reporting were under 4 broad themes;

- i. Risk Assessment Model (Weaknesses in Risk Model, Technology, TBML activity inc. tax evasion, External Agencies)
- ii. Internal Audit (Corporate AML Risk, Outsourcing, Accountable, Regulator)
- iii. Training in TBML (Resources, External Agencies, Investigative Skills)
- iv. Future Direction (future priorities plus any comments from other sections)

Within the next section the topics discussed are supported by references to the actual respondent who raised the issue. These have been coded ⁸¹⁵ as R = respondent followed by their online interview code generated by the survey website. Although it doesn't inform the reader as to who made the comments, it does help to verify that different individuals raised points and to illustrate where several people all made the same type of comment.

5.6.2 Risk Assessment Model

Risk assessment is key to any strategy to detect TBML activity and it underpinned many of the suggestions made by respondents during the interviews. It was also the category that received the highest number of

⁸¹⁵ R= respondent, this number is from the online interview sheet which was generated through the smartsurvey website offering the participant anonymity whilst also allowing me to know who they were.

coding segments. Within this code a number of themes emerged and these are reported on separately in the section below.

5.6.2.1 Risk Avoidance versus Risk Aversion

A statement made by one respondent reflected the overall message from this section “*I think the main risk is not doing the TBML risk properly*” (R7508). Another respondent (R7280) highlighted that incomplete TBML risk assessments due to resources or lack of familiarity could prove to be particularly challenging.

There was a general acceptance of the need for risk assessment and this risk assessment model should operate from a premise of averting risk rather than avoiding or ignoring risk and should be consistent across all units of the bank including business planning and governance structures (R4731). In order for this to be achieved there needs to be a good understanding of the types of risk the bank can be exposed to through money laundering, financial crime and TBML. The simplicity of some of the current risk assessment models was highlighted as problematic (R9498) with the potential for staff to either override the system or unintentionally undermine it through providing low level diligent reports.

Some cases were cited by respondents where banks had decided to close certain operations in countries as they were deemed as too high a risk (R8718). The fact that this may need to happen more often was reflected in this response, “*The financial services industry needs to*

understand its wider responsibility.” (R8884). The lack of understanding of TBML by management and the inability to see it as a threat to the financial sector was also mentioned by other respondents (R9191).

Other respondents (R0839) saw the potential for smaller banks to become specialized in trade finance and be better prepared for TBML assessment. This linked into the point made (R 4909) that understanding your client and their business was a clear component for any TBML risk assessment scheme.

5.6.2.2 Developing Risk Management Expertise

One suggestion and a possible future trend for smaller banks is to focus on a smaller range of client base (R0839) operating within determined and specific business areas. This would enable expertise and knowledge of the businesses and likely transactions to be developed over time and ensure that risk assessment was less onerous (R4731). This would also provide a more positive approach than the current dilemma facing banks of losing clients (R9191) due to onerous AML checks that could ultimately send the client to another institution anyway.

Even though it was suggested by one external academic researcher and trainer in TBML that the fear of upsetting key political figures seems to underpin some strategies within banks rather than developing good governance structures (R9191), many other respondents identified as a

bigger problem, the need to strike a balance between the needs of the business client and the RBA of risk assessment (R6261).

It would appear to make better business sense to increase profit by specialising rather than being constantly worried about AML compliance breaches and the costs involved. Again, one respondent identified many advantages that a smaller specialized bank in trade finance would have over the generic bigger banks when it came to TBML risk assessment (R0839).

One respondent identified the level of expertise needed by describing that when a bank undertakes the risk assessment process for a new client “*banks need to examine the intrinsic nature of the business and assess the risks involved.*” (R1430). This can only be achieved if there is the appropriate amount of knowledge available for this particular business venture and if the bank makes the effort to get to know the client’s business well (R8718, R0839, R4909) including the need to review existing clients and ensure that CDD checks are still up to date and appropriate (R3734).

In larger banks a specific and dedicated trade function is needed to deal with the concerns associated with trade finance risk. This unit could possibly develop stronger links with relevant external trade related organisations such as customs and law enforcement (R8718). It was emphasised that TBML is only likely to expand and become more prolific

in the future and so investment into addressing this issue cannot be delayed any further (R7508).

It was acknowledged several times under the training section that respondents identified a clear lack of expertise on TBML within the banking sector. And that this was potentially detrimental to developing a sound risk based assessment for TBML.

5.6.2.3 Understanding Trade Specific Risks

The nature of transnational trade transactions means that there are a multitude of risks that the client can be exposed to in any regular trading agreement such as customer risk, market risk, and commodity risk. This is before money laundering and illegal trade activities are considered (R4412). Even when trade transactions may appear to be legitimate the fact that many legitimate goods can be used for non-legitimate purposes adds in another layer of complexity (R4731), a weakness that has already been highlighted by the last thematic review of the UK by the FCA.⁸¹⁶ It was generally agreed that a simple checklist system was not adequate enough to cover the complexities of trade based money laundering (R4731), although some countries did not have any regulatory requirement to detect TBML per se (R1192).

⁸¹⁶FCA (2013) Bank's Control of Financial Crime Risks in Trade Finance. London: Financial Conduct Authority.
<https://www.fca.org.uk/static/documents/thematic-reviews/tr-13-03.pdf>

The challenges of simplified risk matrices were also raised as an inappropriate tool for detecting the complexity of TBML (R7062).

5.6.2.4 Standardised Operations

For larger international businesses operating in different jurisdictions there is the added challenge of developing consistently across the offices (R1618) but at the same time developing localised risk assessment protocols and procedures (R4731).

5.6.2.5 Know Your Customer

One of the key tools in any ML risk assessment is to know the customer well (R7508), along with having in-depth knowledge of the business or trade being undertaken (R9773). There were several concerns raised in relation to the confidentiality of clients being compromised, through increased KYC research. However, some respondents stated very clearly that the bank was a partner in these transactions and in that capacity they had every entitlement to clarify concerns in order to be sure that they were not participating in a potentially illegal transaction (R5800).

5.6.2.6 Beneficial Ownership

Beneficial ownership information is also a component of understanding the client and the businesses they deal with, and some respondents were clear that this should not be construed as an infringement of privacy rights (R7508). After all some money laundering schemes take advantage of the client and some transactions may occur without the client's full knowledge or permission, so it is also to safeguard client's businesses. Another respondent also highlighted that since the bank is involved in the transaction then asking for further clarification is not a breach of confidentiality (R5800), so long as the information is looked after within the bank. However, corporate clients who were expecting to keep information secret could no longer expect this level of collusion from the banks moving forwards (R9407). This process should be undertaken when first establishing a business relationship with the client (R3315), although due to the nature of TBML activity approaching established business owners this may also need to be updated or undertaken on a more regular basis. However, the challenges of trying to scrutinise complex businesses across different jurisdictions was raised (R1618).

5.6.2.7 Risk Assessment Tools

One of the challenges mentioned by respondents was whether TBML risk assessment is separate to other AML controls (R1192) or whether the two should be considered part of the same system. The reason that might be considered separate is because of the nature of the trade transactions and the fact that most AML tools are designed for non-

trade based accounts (R1192). However, this does not mean that a more generic financial crime risk assessment tool could not be developed to encompass all kinds of crime was one suggestion (R4869).

Several respondents stated that TBML detection is part of the overall AML process (R9068, R4869) and so this should not be seen as anything too big or out of the capacity for many organisations, However, other respondents highlighted that a strong AML base was needed first by the banks before TBML could be dealt with effectively “*The response of banks is dependent on regulatory pressure to some extent, if basic AML measures are not in place then TBML definitely will not be possible.*” (R9498). It was also emphasised that all AML work should be integrated across the organisation and should avoid isolating the work (R6427). However, it was acknowledged that most risk assessment models at the moment are focused on tick boxes and red flags based on standard and typical TBML typologies (R7877). The challenge faced was how to be more stringent on risk assessment without unduly affecting businesses and losing trade clients as a result. The time element of following up on reports can also be an inhibitor for small businesses, one respondent identified letters of credit searches taking a week to be returned (R6704). However, it was stated that banks and financial services needed to embrace this level of risk assessment or else consider leaving the trade finance sector completely (R8985).

In summary the risk assessment model should be comprised of the following components.

- A. KYC norms stringently implemented
 - a. With a system for quarantining accounts
 - b. Getting to know clients well - and keeping client information up to date
 - c. Using behavioural risk assessment techniques
 - d. Monitoring transactions for red flags and putting a hold on such accounts (to bring about transparency)
- B. Has to be a predominately human rather than technological assessment
 - a. Need to assess and incorporate technology where appropriate
- C. Need to know the client's business well
- D. Identify changes that could introduce additional risk - e.g. New trading routes and new countries that existing clients branch into.

5.6.2.8 Weaknesses in TBML Risk Assessment

A separate code was established for comments that focused specifically on identified weaknesses in the current risk assessment approaches.

5.6.2.9 Risk Matrices

Risk matrices are commonly used in banking and there are a number of different models in use according to the replies, However, many smaller institutions tend to use simpler models which are not always the most effective system to combat different money laundering schemes *“Some smaller banks use basic risk assessments and use the simple risk matrix (H,M,L) and by default the middle risk tends to get selected, compared to other models which can be very complicated, as seen in larger financial institutions which have highly developed systems in place”* (R9498).

5.6.2.10 Knowledge Gap

One of the gaps in the current AML assessment approach is that money laundering risk assessment relies on the quality of information that is being gathered and conveyed up to other departments. How, or if this information is passed on, can sometimes be influenced by commercial or profit considerations (R4731) rather than risk interests. Trade finance information is often not understood by bank staff outside of the trade finance unit (R7889, R7508). A system of behavioural risk management was suggested (R8884), i.e. focus on the inherent risks from within the bank due to lack of training etc. as a means to prevent events occurring that might cause risky transactions occurring. Ultimately the quality of information being gathered would be dependent upon *“the capacity and*

skill set of those internally responsible for financial crime" (R9068). Some of the larger banks have specific financial crime units and these often utilise the skills of former police investigators (R9773), these skills could be transferred across other units within the bank and specially to front office staff.

Another weakness is that the quality of information may be very poor, especially if only part of a series of transactions are occurring through the bank (R9068). This would mean that the level of expertise needs to be quite high amongst the bank staff, in order for these cases to be flagged as potential ML problems. Several respondents raised the issue of the role of the front office staff as being the first line of defence and so the knowledge and skillset needs to be improved at this level (R1551) as a major priority. There is also the need to constantly update client information, since many money laundering schemes are now using established clients as an entry point into the banking sector so many established clients can no longer be assumed to be low risk.

5.6.2.11 Geographical Risk

Many banks have offices across the globe and have tended traditionally to assume that the standards of money laundering control and risk assessment are comparable across offices within the same bank (R8718). Recent cases such as the HBUS in the United States and their trust in their Mexican affiliate of HSBC proved how ill-founded this

assumption was. In future each country will have to assess independently regardless of the name of the bank. Similarly, many banks have facilitated large cash transactions due to cultural reasons often linked to a lack of formal banking structures in certain areas of the globe. However, the increased use of digital payment technology means that most countries now have access to electronic payment transfer systems, albeit with a different set of risks. Bank staff will need to maintain research and awareness of the situations globally in relation to cash and electronic systems available. However, the reality is that many banks will be unable to complete detailed investigations into client's accounts when multiple jurisdictions are involved *"The problem is being consistent - how can banks scrutinise complex business relationships across jurisdictional boundaries for instance?"* (R1618).

5.6.2.12 A Step Too Far

The respondents were asked, as part of one of the questions, whether TBML detection was perhaps a step too far for many banks and financial services at the moment, some respondents agreed that it was (R9602, R9321). Other respondents highlighted that banks are not a crime fighting force (R1192). However, it was also acknowledged that it is the very lack of knowledge of criminal behaviour and the limited understanding of how the banks are being placed at risk through criminal ingenuity, that is perhaps one of the biggest risks faced by the banks today (R7979).

The current system of KYC data and intelligence gathering is considered by some clients to be onerous enough. The feeling from some respondents was that if this process becomes any more complicated and burdensome on the client they will leave and use less accountable and also less traceable financial mechanisms (R1618).

5.6.2.13 Understanding Financial Crime

One weakness that was raised by respondents (R9773) was that banks are businesses and work with their clients who are also business owners. There is not really an understanding of financial crime within either group, but rather a focus on ensuring the business is not slowed down through bureaucracy. If the system gets too complicated this could encourage bank staff to start circumventing the protocols in order to facilitate the client. This was illustrated through the HBUS case ⁸¹⁷ where country filters were routinely bypassed because it delayed loan approval by some considerable time. Another factor that was highlighted was that in a bonus driven culture the need to secure deals by staff might be advantageous to the criminal clients, who would be willing to pay the higher fees in order to launder money into the system (R7979).

⁸¹⁷ Homeland Security. (2012). HSBC exposed US financial system to money laundering, drug, terrorist financing risks. From permanent sub committee on investigations. US Senate. Retrieved from <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/us-vulnerabilities-to-money-laundering-drugs-and-terrorist-financing-hsbc-case-history> accessed 4 August 2015

5.6.2.14 Cost of TBML Risk Assessment

There are a number of resource implications in undertaking money laundering and TBML risk assessment. Firstly, many of the units involved are not seen as profit centres within the bank but cost centres such as the trade finance unit (R7889), AML compliance and internal audit. This means that in a competitive environment a profit focused approach tends to be adopted and prioritised (R7889). This included staff and also investment into tuning and improving technological approaches within the bank (R9321).

However, increased fines and the loss of profit through negative reputational risk are beginning to influence change at this level slightly. Respondents stated that directors need to take responsibility in TBML detection (R7979) which would mean assigning the right resources including appropriate staff numbers, access to relevant training and enhancing a culture of risk assessment to detect and stop all forms of money laundering across all units within the bank.

5.6.2.15 Specific TBML reporting officer

This suggestion was probably aimed at larger organisations that already have in place a structure of MLROs or money laundering reporting officers. On the one hand experts had called for TBML and ML to remain together and avoid confusion, However, in this suggestion there was

recognition of the different nature of TBML. One expert suggested that the TBML officers could do some of the follow up research after suspicious reports had been raised by front office and non AML compliance staff across the bank (R9602). This role might also overlap with the current position of money laundering reporting officer (MLRO), who in some cases was seen as a legal protection for staff, who felt they were relieved of any responsibility once they had reported their suspicions onto this post *“Banks and trading companies have to have Money Laundering Reporting officers to whom suspicious transactions must be reported, only if so reported will an employee avoid being charged with aiding and abetting.”* (R7979).

It was felt by several respondents that risk assessment was basically a systems problem (R9773) and that once the system was operating effectively this would be most of the battle won. *“TBML is a practical rather than a theoretical problem and we need practical solutions and policies.”* (R9498).

5.6.2.16 Technology and Risk Assessment

One of the concerns raised by respondents was how to deal with the vast amount of data that could be generated through analysing trade transactions. The problem was further compounded by the fact that few people knew what they were looking for from this data and even if they did time was limited and the data quantities quite vast. The use of technology

was mentioned a number of times as one possible solution to managing the data problem, along with the need to develop good AML software which was described as lacking in the sector (R9321). The main IT suggestions have been described in more detail in the section below.

5.6.2.17 Digital Document Formats

One of the practical issues of examining trade documents is that most of these are physical documents (R1430) that have to be reviewed by hand and acquired from various sources. If some of this information could be developed (or it could be scanned and sent as electronic attachments) and then analysed through TBML software, this could assist in speeding up the automation process for approving letters of credit or other trade finance schemes. One example from the UK mentioned a centralised service for commercial companies that exists, whereby trading documents could be verified quickly on a yes/no basis to the banks (R1192).

5.6.2.18 Linking to Current AML Software programmes

It was acknowledged that many banks do use automated monitoring systems to screen messages and emails (R7877). However, the difficulty is that the overall system of monitoring and IT is ineffective, *“the overall approach is not structured to provide such assurance and systems are not capable of handling such volume of information.”* (R8884). Additional software needs to be developed or adapted to include being able to scan for sanctioned or suspicious parties (R5800), possibly linked to Interpol databases. Some systems are currently being used, possibly by the bigger banks and include systems such as;

- Worldcheck

- HM Treasury (for dual use goods)
- International Maritime Bureau (to check vessel name and flag)
- IMF's Direction of Trade Statistics (DOTS)
- The United Nation's Comtrade database

5.6.2.19 Managing Trade Data

The problem of access to good software to screen goods, ports and places was raised as one area of concern (R4412). Other respondents identified weaknesses in the current red flag system such as the UK regulators advice to check for price anomalies.

“How would a banker know the market price for all the various commodities they work with? Especially taken into account that the chosen trade term may affect the price as well.” (R4412). Another comment was “Banks tend to not look into over-pricing / under-pricing or irregularities on every occasion - how can they?” (R1192)

One suggestion was that automated monitoring systems needed to focus on TBML type transactions (R8718). This was especially important given the large volume of trade transactions occurring at any one time which makes it difficult for staff to spot suspicious transactions (R7979).

The use of Zdanowicz's trade database (based on US exports and imports) as a system for exploring trade anomalies was suggested by one respondent (R6039) as a system that has been invented but not yet proven to be effective. They suggested that perhaps banks should be making greater use of this advancement in trade patterns rather than constantly seeking out their own anomalies each time. However, other respondents also stated the need for specific TBML algorithms (R8718) and the trade data results from Zdanowicz could then be used as the basis for developing such an algorithm. Other respondents suggested that the complexities and number of variables within TBML were too many to allow it to be fully automated (R9407, R7889).

5.6.2.20 Using Technology to Manage External Risks

Another use of technology that was suggested (R8718) was to assist in the research needed for dynamic risk assessment processes. *"Banks should as far as possible use technology to enhance their control environment and align their control measures globally to assist them in identifying higher risk branches in other territories."* (R8718).

5.6.2.21 TBML Data Management

A training consultancy firm that specialises in TBML training made this statement on a recent social media site, in relation to the possibility of developing specific TBML software to assist in risk assessment.

“for TBML, there is simply no substitute for the human element in detecting possibly suspicious behaviour in trade finance. Automation of detection would be possible if automation of processing were possible. For trade finance, automated processing of transactions is simply not possible, due to the number of variables and variances in letters of credit, documentary collections, etc... As a result, the automation of detection is equally impossible, therefore what is left is the human element, a tool that can only be honed with specialised training” (Manchester, 2015).⁸¹⁸

Other documents on software systems and risk assessment such as the ACAMS White paper on Developing a Risk Assessment Tool for Internal Audit by Estreich⁸¹⁹ provides an overview of some of the AML factors that internal audit needs to consider. However, in trying to be all encompassing of the AML issues, the paper ends up presenting a very

⁸¹⁸ Manchester, K (2015) TBML Forum https://www.linkedin.com/groupItem?view=&item=5965864558089244675&type=member&gid=6509147&trk=eml-b2_anet_digest-hero-1-hero-disc-disc-0&midToken=AQE00DQUTjTeHw&fromEmail=fromEmail&ut=2EQiTcnJypwSE1 accessed 4 March 2015

⁸¹⁹ Estreich, J. (2013). How to build an audit risk assessment tool to combat money laundering and terrorist financing. [White Paper] (White Paper). ACAMS

complicated risk assessment tool that ultimately is led by data management processes rather than audit analysis.

This research paper is focusing specifically on TBML and so the AML risk assessment needs to be focused specifically on trade finance operations within the bank.

5.7 Internal Audit

One of the areas of risk assessment and TBML detection that this research was keen to explore, was the relationship between internal audit and AML compliance. This was primarily because a recent report from the FCA ⁸²⁰ (2013) had suggested that internal audit should have a stronger role and become more involved in AML risk assessment processes and other audit agencies such as PwC ⁸²¹ had also suggested similar sentiments.

“We found that some staff in compliance, internal audit and legal functions had a limited understanding of trade based money laundering risks. This meant they were unable to oversee or challenge the business effectively on decisions taken” (FCA, 2013, p35).

5.7.1 Role of Internal Audit

There was little evidence in the literature review that this issue of an increased role in AML risk assessment had been studied academically, or that suitable guidelines had been developed at an empirical level to support the FCA suggestion. In order to address this issue the interview

⁸²⁰ FCA. (2013). Bank's control of financial crime risks in trade finance. London: Financial Conduct Authority.

⁸²¹ PWC. (2014b). Internal audit holding the line on BSA/AML compliance. Retrieved from <http://antimoneylaundering-fiba.com/files/1499.pdf>

questions in this research included one question that was focused specifically on the role that the respondents saw for internal audit within TBML and AML compliance and risk assessment processes. The responses were mixed in terms of whether internal audit should become more involved or whether this would compromise their independence when reporting to the audit committee or management. In total 63% of the responses agreed that internal audit should have a role to play in AML compliance process but most agreed that this was separate to the role of AML compliance itself. The full range of suggestions for internal audit have been categorised into 2 main themes which are –the role of internal audit and the gaps or reasons why IA involvement in TBML would not be appropriate (See figure 4 on the next page).

There were a variety of opinions regarding the role of IA, some respondents felt that there should be a greater level of involvement whilst others viewed IA as lacking the expertise to be able to contribute meaningfully to TBML risk assessment processes.

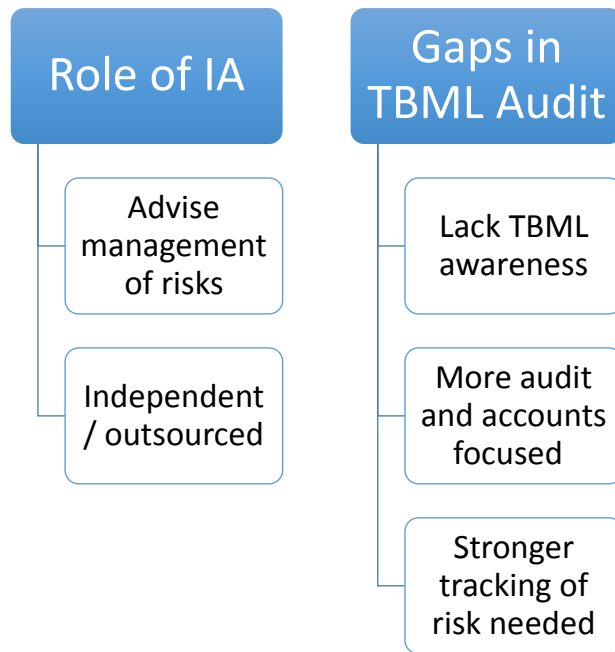


Figure 4: Role of IA

At one end of the spectrum there were some respondents who felt that IA should be fully integrated with AML compliance - *“AML unit should be part of internal audit in order to effectively manage anti money laundering activities of banks”* (Respondent 9321). Another respondent suggested that internal audit should be one of a team of players involved in ongoing development and monitoring *“Audit, along with other appropriate departments such as legal, compliance, tax etc. Must be involved in developing risk assessment approach.”* (Respondent 8985). Stronger links between internal unit and trade units was another suggestion (Respondent 4412).

This might be a more relevant strategy for smaller companies as one respondent identified *“most small banks do not have the resources to*

do this work and so have to use them [IA]. The monitoring of the work tends to be either compliance or internal audit" (Respondent 1551). In larger banks the options for integration are probably less favourable and internal audit and compliance would be very separate units.

5.7.1.1 Separate Role - independent as 3rd line of defence

The position that was voiced by a larger number of the respondents was that internal audit already has a very clear role to play in AML compliance by providing independent assurance through their third line of defence role (R9498), i.e., after risk management has been undertaken by the front office and AML compliance sections. One of the reasons suggested for maintaining this clear role distinction was to enable management to uncover any problems, rather than have them exposed by the regulator. *"Senior management would prefer internal audit to find something rather than the regulators"* (R 9068).

Another respondent stated very clearly that internal audit should not be *"creating the risk assessment"* (R7508) but track *"the evaluation of the risk process and whether the bank is adapting to changes"* (R 9407). However, it was recognised that internal audit still needed expertise in TBML as part of its 3rd line of defence role in supporting governance and the reporting to the audit committee.

“The challenge is to ensure that IA can report up through the chain of command in governance any issues that they identify. For that there needs to be a level of expertise within IAF on AML/TBML.” (R9498).

5.7.2 Internal Auditing of AML

Nearly all of the respondents felt that at some level, that regardless of their perception of internal audit roles, there was still recognition that internal audit had to change how it tackled AML audits.

This suggested that possibly AML compliance and AML auditing are two distinct areas of expertise. Therefore, an effective AML process needs to consist of both components i.e. audit and compliance operating as effectively and as efficiently as possible. One respondent identified that with increased attention to AML compliance at a governance level, then there is automatically a need for improved auditing services both internal and externally within the bank to meet this need (R7508).

“It is important that IAF is able to identify the potential threats and risks to the organisation and address them in a timely manner, therefore the ability to identify and work on high risk issues is paramount in the work of IA and TBML is one of those risks.” (R9498).

One of the difficulties identified was the current focus within banking, on compliance needs rather than identifying risk. One respondent stated that there needed to be a shift in attitude and greater awareness towards the risk of criminal liability, *“At present there is a focus on compliance with standards as the basis for a true and fair view. However, the threat of conviction for money laundering could be a significant business liability for banks and therefore better scrutiny over the management of risk would be appropriate.”* (R1618). Internal audit should also present the audit report in relation to the specific context of the bank so that the findings and recommendations for change are practical and relevant to the other units in the bank, *“The reports from auditors need to be set into the specific context of the bank so they can be used most effectively”* (R9498).

5.7.2.1 Risk Auditing

The danger with risk auditing is when it is left to a yes/no process of compliance in ticking boxes (R8884), the audit has to move beyond this stage and provide useful and relevant feedback to the AML compliance section and the audit committee. In particular, a clear understanding of risk drivers and the suitability of the AML framework in place to overcome these drivers (R8884) needs to be at the core of the audit report, *“Internal audit must determine the risks of the business in its various product sets, geographic footprint and customer characteristics”* (R9407). In addition, it

was named that management in turn needed to act upon any red flag alerts that internal audit was raising (R9321), especially with regards to potential weaknesses or gaps in the risk assessment approach being implemented, *“Internal audit must match the risks identified with the defences mounted by the bank. If there are large loopholes or weak areas in defences, they must be identified to the audit committee and resolved ASAP”* (R9407).

The respondents made several suggestions as to how the AML audit might occur and these have been compiled as a revised list below:

- a) Make sure that adequate up to date policies and procedures are in place for TBML.
- b) Check that every staff member has successfully completed the mandatory training, which is refreshed regularly.
- c) Ensure that reports are being correctly handled by the MLRO.
- d) Ensure that executive and non-executive directors are receiving regular and accurate reports.
- e) Review and challenge were necessary the frameworks in place.
- f) Including a review of the AML controls being used by the bank.
- g) Periodically review and independently verify identified high risk cases.
- h) Review the SAR reporting process.
- i) Routine audits could potentially undermine the 2nd stage of defence system.

- j) Follow the trail of SARs to review the effectiveness of the risk assessment tools rather than just commenting on the presence of the tools.
- k) Review the outputs sent to FIUs to assess the quality of the reports being sent.
- l) Be aware of current political and economic risks related to sanction regimes.
- m) Have a clear understanding of the business risks being faced by the bank e.g. geography, business products and customer characteristics.

Underpinning this list of AML audit skills and tasks is the understanding that the expertise of internal auditors is capable and skilled enough for the job. However, many of the respondents questioned whether this was the case currently.

5.7.3 Lack of TBML Expertise

One of the reasons that was given for not involving IA in the TBML risk assessment development was that there was not enough expertise within most IA units to manage this, *“Internal auditors are rarely experts in financial crime, so necessarily their role tends to be more of a ‘tick box’ approach looking at the compliance with the banks policies and procedures”* (R9068). However, at the same time they are still expected to

audit TBML risk assessment processes and report on the levels of AML compliance and the gaps in the system.

Another respondent (R8718) agreed with the above comments but suggested that outsourced expertise could be used to supplement gaps in IA knowledge. However, there was still a need for internal audit to up skill in issues related to trade finance since outsourcing has a cost associated with it. This was mentioned by another respondent (R7877) who also added that the lack of trade finance knowledge was another reason why IA did not currently appear to have a strong role to play in TBML auditing. Yet another response stated *“I don’t think it [IA] generally has the skills to be able to deal with the complex risk issues faced here”* (R1618).

To be effective one respondent suggested that internal audit needs to invest in staff and ensure the recruitment of appropriate skills *“[IA] has to attract good people who wish to make a longer-term commitment to be effective”* (R1551). A longer-term strategy supported with adequate training in TBML and AML compliance was therefore seen as the biggest issue to be addressed by internal audit, from this group of respondents.

What was less clear from these respondents was if the skill level of internal auditors was raised, would they then been perceived as having a greater role to play in risk assessment? If this was to be the case then a future priority for all organisations would be to improve risk assessment

models and processes, and up skill internal auditors in this field of expertise.

5.7.3.1 Summary Internal Audit

Although most respondents were clearly articulating the range of skills that are needed for an effective AML audit, there was also agreement that many of these skills were not currently available within most internal audit departments and units. This would imply that AML and TBML auditing is a future good practice strategy for many organisations especially smaller banks and financial companies, rather than a reflection of actual current practice. However, it does have implications for some of the other themes in this section especially training in TBML since there is now a distinction between TBML compliance and TBML auditing skills.

5.7.4 Internal Audit and Governance

One of the key themes that respondents were asked to comment upon was accountability, and where it lay within the banking structure for ensuring that AML compliance was undertaken effectively. Responses have been sub divided into the five themes that emerged under this general heading, these were:

- Management;
- Banking culture;
- Regulators;
- Resources;
- Audit.

5.7.5 Management

Some respondents believed that senior level management within many organisations was lacking in leadership capacity on AML risk management. They appeared to lack a strong level of commitment to addressing the gaps in the AML policies was one opinion (R9321). This could be rectified in one suggestion by having a greater level of involvement by management and audit committees in the oversight of AML and TBML systems (R9191). This could be achieved by management conducting its own assessment of the bank's exposure and risk to TBML (R1192), and to use that as the basis for directing internal audit of its AML priorities (R8884). In practical terms this would probably be done by external audit, which is largely informed by internal audit, which in turn tends to be influenced by the existing governance structure. Therefore, there is the potential for this approach to simply reiterate the current practice.

It was also stressed that the lead needs to come from the top (R7508), so that the correct culture of the bank towards AML compliance was established. However, as with all risk assessment processes a detailed understanding of TBML would be needed first, in order to assess the risk faced by the bank. Otherwise a superficial and misleading analysis could be undertaken that later prevents other units such as audit or compliance from raising concerns, *"They need to develop a stronger understanding of the topic and a willingness to accept that AML is a*

priority issue for the bank” (R9498). Although one suggestion was that the directors do not need to be involved directly at a practical level in AML compliance (R7508), at the same time the legal responsibilities do rest with the board (R7979). Therefore, there is a level of culpability that needs to be covered in any risk assessment system that includes the entire governance structure. This includes the feeds of information that need to reach the appropriate levels within the governance and audit structures and which need to be fed independently of the profit focus of the business (R4731).

5.7.6 Culture of the Bank

One of the concerns raised by the respondents was the lack of a supportive culture towards fully implementing AML compliance systems. In particular, one respondent stated that AML compliance can sometimes be a paper exercise especially when it came to dealing with war torn countries such as Iraq or Syria (R9321) or weak economies in developing countries. The importance of the integrity of the financial services was mentioned (R8884) as a new area of priority for many banks to take on “*A lot depends on the support, corporate guidance and the priority that they give to AML*” (R9498). Following the global economic downturn many more members of the public have become sceptical of the traditional mainstream banking ethos and culture. They are not happy with the profit at any price approach to business, and factors such as environmental sustainability, ethical investments and supporting community development

have become keen factors of interest for the bank's client nowadays. This in turn requires a cultural shift in the bank's governance structure to ensure that these new areas of interest are represented amongst their services and prioritised within the business plans and distribution of resources.

One of the influencing factors in accountability is the number of legal cases taken against bank's which is beginning to influence corporate attitudes towards compliance, *"Due to enormous fines, banks are facing the reality that they must evaluate the risks their customers impose for TBML"* (R9407).

5.7.7 Guidance and Resource Material / Regulators

Another issue that was identified was the lack of guidance or clear policies on internal compliance procedures (R8985, R8246). This was also reflected in the lack of appropriate supervision for compliance staff (R8985). The role of the regulator was also mentioned because without clear guidance on what is expected of banks (R1192), it would be difficult for an appropriate and relevant risk assessment process to be put in place. AML guidance needs to be directed specifically at governance so everyone is clear on their role within the process (R9773) rather than it being left to AML compliance alone. Another respondent named how banks might respond to this clarity saying that they will take the role being

prescribed but nothing more otherwise client confidence might be compromised (R9602). Another argument could be that client confidence might be increased if they thought the bank was doing everything possible to alleviate potential money laundering threats appearing in the bank. Leadership needed to come from the bank it was suggested (R6704), since then the culture and approach of all staff would be consistent.

Even in small organisations the overlap of roles such as credit or finance managers taking on MLRO roles was highlighted as problematic (R7979).

5.7.8 External Audit

The use of effective external audit companies to give a thorough analysis of the risk assessment procedures was suggested, but this was also questioned as a process since “*external audit companies fear losing a client more than they fear inspection of their effectiveness*” (R9191). This would suggest that the remit given by governance would need to be very clear to the external agency, that what they wanted was a critical appraisal of the risk assessment systems being used and that they expected to receive a critical report highlighting areas for change.

5.7.9 Corporate Responsibility

One of the questions that generated a broader range and array of answers was on the overall corporate responsibility that a bank or financial service had towards understanding AML risk. There were very mixed responses from the experts as to whether the banking sector as a whole was ready to address the complexities that modern ML scheme were presenting. The comments ranged from “*I do not believe the Banking Industry as a whole is ready to focus on TBML/AML factors*” (R8884), through to the more positive “*I think that most banks are handling AML fairly well*” (R7508). The following section has divided the responses into two main areas - the challenges that banks are currently facing and future priorities that banks will need to embrace moving forwards. The focus of the question was on the overall banking approach and its corporate responsibility. This would include prioritisation of resources from governance and allocating the level of importance that AML compliance would occupy within future strategic plans.

5.7.10 Resources

One of the many indicators of TBML activity are discrepancies in trade documentation, and yet the biggest challenge facing banks is how to have the resources and access to data to verify this level of deception. One expert suggested this was not the role of banks at all (R1192), and continued to support the point by highlighting that in their sector there were no statutory requirements for TBML monitoring or reporting in their

country. This latter point is probably because TBML is covered under the generic ML requirements, which links into an issue that was raised by several experts when they stated that TBML shouldn't be separated from other forms of financial crime.

Even if some experts (R9602, R6039, R1192, R0994, R7062, R5602) felt it was a step too far to start investigating potential TBML activity, it was noted that trade finance was going to be area of increasing concern (R7508). The challenge of secrecy was another point of concern and often seems to be raised and a reason why banks should not be passing information onto the relevant authorities. This was clarified by one expert who reiterated an earlier point that it is not a breach of confidentiality to seek more information (especially linked to acquiring beneficial ownership information) on a business transaction that the bank will be a part of (R5800). Generally, there was scepticism that the staff who work in a bank and therefore are trained in supporting a profit-making venture, will have the appropriate level of understanding about money laundering, that is required for AML compliance and risk assessment work (R9773, R8718). Perhaps understandably they want to speed up processes for their clients, rather than slow them down and risk losing the business altogether (R9773). In addition, trade finance along with AML compliance and audit are all considered as cost centres to the bank rather than profit centres, and therefore these will be viewed as lower in priority. Although training was mentioned throughout the interviews there was also

some emphasis placed on changing the culture of the bank or organisation towards prioritising AML compliance and detection.

An additional challenge that banks face is the internal challenge of staff who facilitate criminal activity, especially through ignoring warning signs, in order to complete sales and receive bonuses. The bonus culture and reward system in banks is orientated towards profit and sales, it does not encourage risk assessment and reporting (R7979).

5.8 Training TBML

The final area in the interview themes and one of the key areas that respondents were asked about was training in TBML. In particular, they were asked whether the banking sector was open to the use of external training agencies to enhance the knowledge base within the sector and which areas of training were needed.

5.8.1 Use of External Training Agencies

The respondents cautiously approved the use of external agencies, often stipulating that the training had to be relevant and “*competent*”, so that it would provide additional information to that which the bank already had access to within its own skill set (R1430).

There was a suggestion that “*industry forums*” (R1430) or conventions (R6418) might be a more appropriate and relevant mechanism for updating bank staff on current AML issues. Another suggestion was to hold industry forums as well as training (R3668) and another option that was suggested was to have inter organisational training to share practical ideas and scenarios within the industry (R7979). However, given some statements this might be challenging since banks are often quite secretive around their compliance and risk assessment processes, “*Banks are notoriously secretive and do not like opening up and working with outside agencies*” (R1551).

In the meantime, the following statement encapsulated several concerns that respondents expressed regarding the level of expertise present within the banking sector, “*Outside expertise on TBML is needed – as the banks themselves currently do not have the expertise or enough of it*” (R6666).

The biggest problem seemed to be the quality of outside expertise and a strong criticism of current training programmes that were being offered. There was criticism from one respondent that many external agencies are lawyer led and tend to suit corporate organisations more than the banking sector (R7877). Other respondents suggested that much of the current training is at quite a high level (R4412) and perhaps future training needs to focus on becoming more practical, although it was

acknowledged that this is not as straight forward as it may seem, given the complex scope of TBML activity currently available.

There was a consensus that training programmes should be tailor made for each bank and not simply an offering of generic TBML models that could well be outdated by the time the training was delivered. The training should therefore suit the individual staff position (R6666), the region that the bank was operating in (R0994) and for risk assessment suggestions to be cognizant of local cultural practices (R7062).

Due to the changes in methods and systems of money laundering, it was suggested that annual training was not sufficient to capture new trends and methods (R5602). It was also noted that international banks that had offices and branches in different countries would need to look for risk assessment consistency across all the bank offices whilst also being aware of local cultural and regional differences (R0839).

For smaller banks, there could be a greater reliance on external support and expertise “*Especiallly if TBF is a new area for the bank and/or does not have a qualified internal training team.*” (R7508). The complexities of TBML and trade finance processes were raised a number of times such as “*The technicalities of international transfer pricing are not always understood.*” (R1192). There was also a suggestion that compliance staff need to have a thorough understanding of trade finance

risks if TBML is to be detected (R4869), and this could put further strain on the resources and staff in smaller organisations.

There was a repeated emphasis that the training needed to link into the existing approach of the bank and compliment other internal AML processes, *“External training can be useful if the necessary expertise meets internal requirements”* (R 8985). It was also important that all staff became involved in the training (R8985, R9321, R9407, R9068, R6704, R9498) especially the front office and back office staff who were actually processing a lot of the data (R6704). A number of respondents also recommended that trade finance staff should be prioritised for training in TBML detection (R3315), although several suggestions mentioned that the risk assessment framework should ultimately determine who accesses which training and when (R1192). One suggestion was that other forms of training such as e-learning (R1992) could be a way to access outside support in a more cost effective and easier to manage format.

5.8.2 Training Approach

Several respondents identified the need to provide more practical focused training rather than being theory led (R9498). They stated that training should be given by practical experts with experience rather than just scholars (R5800), who tend to have limited practical examples and work related experience. The traditional approach to training about money

laundering is still used which places the emphasis on the placing, layering and integration of money into the financial system. However, many schemes of ML are far more complex today and TBML in particular does not follow this format (R7979), so training needs to be updated.

One of the ways that the respondents identified that the training could be made more relevant was through providing practical findings and highlighting money laundering flaws within the banking context (R9321). Regional examples and realistic scenarios (R9068) were other suggestions to ensure that staff could directly relate to the material and context being presented. This would also increase the motivation to learn if it was seen as directly relevant to their work (R9068, R1551), and would assist in developing a stronger AML culture within the bank, including having the opportunity to challenge existing practices and discuss gaps in the system with the trainers (R5602).

Ideally a broader training programme relating to all aspects of financial crime could be developed linking the different areas of *“identity theft, forgery, tax evasion and terrorist activity”* (R8985), whilst other respondents (R1192, R5800) also stated that TBML should not necessarily be isolated from other fraud and financial crime training since many of them used similar structures. Perhaps at this juncture TBML is one aspect of a broader group of illegal trade activities, which would include tax evasion, capital flight, sanctions evasion and money laundering.

5.8.3 Topics to be Covered

There were several suggestions for specific topics that needed to be covered in any training on TBML. These included the following;

- 1) Explaining the standard typology overviews that the various FIUs work with.
- 2) Identifying and updating the red flag alerts and TBML indicators.
 - a) Recognising that indicators are just that, indicators of possible activity and not definitive.
 - b) Training on the obvious indicators of TBML.
- 3) The use of dual purpose goods and the need for training to explain this further.
- 4) Possible scenarios that may be used in trade finance transactions.
- 5) Old systems such as layering and placing having been replaced by criminals who need to speed up the process and these newer systems needed to be reflected in future training.
- 6) Using live examples or perhaps simulated transactions as part of the training approach.

It was suggested that the risk assessment model should be the key determinant as to what training is required and by which staff (R4869) and that training should be needs-led rather than resource directed (R9498). There were several suggestions relating to the training needs and determining the relevance of information and training required, according

to banking staff positions. For TBML work there has to be some level of understanding on the process of shipping and this needs to be acquired through external agencies and interagency links as well as across the banking units. This information is required in both the home country of the bank and the destination country of the client's trading business.

5.8.4 Guidelines

Several respondents suggested themes for guidelines that could be developed, these included;

- A know how on detecting suspicious activity (R9602).
- Typical TBML transactions.

These guidelines may also serve to provide criminals with information on what banks are doing to stop certain activities and therefore will have a short shelf life for some methods of TBML activity (R7979).

One of the downsides to money laundering activity is that the methods used are constantly changing (R6704), and therefore the implications for training are that banks require some system of constant updates and information sharing. This would be different to many of the other training programmes that the banks employ which can be one-off or have lengthy periods in between refresher courses. In addition, the nature of TBML as a transnational crime means that international examples, especially where practices are changing, would also need to be included in

any training approach (R4412). One respondent identified that at the end of the day *“the effectiveness of the human element is dependent upon the training program provided by the bank”* (R9407).

5.8.5 Investigative Skills

The role of banking in undertaking more in-depth investigations received mixed responses, some respondents felt that this was the role of the police and that regulators and governments needed to focus more on strengthening the agencies who are already trained in this level of work such as law enforcement, *“I am not totally convinced that governments have really exhausted other methods such as good old police work and international cooperation between law enforcement agencies”* (R9602). Another respondent highlighted that most legislation, and especially in the US placed an emphasis on all bodies in the state having a role in AML detection and not placing the responsibility solely on the banking sector.

5.8.6 Future Priorities

There is no doubt that trade will remain a fundamental component of global banking and economic development. One expert pointed to the trade not aid policies, that will encourage investment and trading into the developing economies. In response to this area of growth the banking sector will need to develop strong KYC and CDD approaches, in order to

protect the financial sector against possible fraudulent trading and the illicit transfer of goods and money (R4731). One of the aspects of banking that will have to change as suggested by one expert, was their exclusive focus on revenue performance rather than considering “*the implications of the integrity of the financial market*” (R8884). In other words, a continued inward view of banking tended to ignore how public perception could be weakened through such a narrow focus, at the expense of the bigger financial picture. Especially, since clients and the media in this era, are more aware of what is happening globally now and the role that the banking sector plays in supporting criminal activity, if it is not deterred.

There was one suggestion that the focus for AML compliance should be on what the bank is doing rather than always focusing on client transactions (R8884). However, as with many suggestions there is the need for a strong knowledge base to be established first within the bank, so that staff and auditors know what should be in place before they can offer critiques and evaluations on what is missing. Developing a stronger internal audit system was one means through which this could be achieved (R7508), whilst placing more emphasis on the role of management in financial crime was another suggestion (R4869).

Training was an underlying theme that was raised under many of the question headings and under corporate responsibility it was mentioned that there is an obligation on the behalf of management to take a firm stance against ML activity (R6704), and to ensure that all staff received

the appropriate amount of training (R3315). One expert stated that in their organisation (R9773) the financial crime unit or security department would often be comprised of ex-police or law enforcement officers. This would bring an increased level of awareness of investigative skills into the organisation and could become more common place in the future, especially in many of the larger banks in order to have constant and quick access to this type of skill level. The need for banks to acquire these skills in some shape or form was suggested by several experts (R8985).

5.8.7 Secondary Data Reports

One of the limitations of the research project was acquiring the level of reach required to justify the findings as relevant and representative of the banking sector. There were only so many experts that could be contacted through a simple online survey and interview approach, within the limited timescale and using the contacts available to the researcher. In order to ensure that the context and suggestions being made were representative of the sector, a number of industry based surveys were examined that had access to a larger database of experts. Two reports in particular were deemed as especially relevant, these were the PWC report on Internal Audit (2014) ⁸²² and the Financial Conduct Authority report (2013) ⁸²³ on AML compliance.

⁸²² PwC. (2014). Internal audit holding the line on BSA/AML compliance. Available at: <http://antimoneylaundering-fiba.com/files/1499.pdf>

⁸²³ FCA. (2013). Bank's control of financial crime risks in trade finance. London: Financial Conduct Authority.

Both of these organisations used their knowledge and experience within the sector to share opinions, and in the FCA report to share outcomes of small scale research review, on topics relevant to this research project.

5.8.8 PWC Report (2014): Internal audit holding the line on BSA/AML compliance

The importance of AML compliance has become more widespread, possibly due to the increase in court cases taken against banks by regulators for lack of AML compliance such as HSBC ⁸²⁴ or by clients for failing to implement AML reporting requirements. The role of internal audit has also become a focus of the conversation in some practitioner handbooks and guidelines. One of these publications that the research reviewed is the PWC publication. In their publication on Internal Audit and AML compliance they state very clearly that a shift has occurred within the internal audit role.

“The days of the BSA/AML checklist audits are well behind us. BSA/AML compliance is now heavily scrutinized by the regulators for all banks, from the small local banks to the largest US financial institutions. Having the right team with the right skills is not enough; banks must take a

⁸²⁴ Homeland Security. (2012). HSBC exposed US financial system to money laundering, drug, terrorist financing risks. From permanent sub committee on investigations. US Senate. Retrieved from: <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/us-vulnerabilities-to-money-laundering-drugs-and-terrorist-financing-hsbc-case-history> accessed 4 August 2015

risk-based approach in developing an efficient and strong BSA/AML internal audit program—one that can hold the line on compliance.”⁸²⁵

The PWC report ⁸²⁶ reiterates the traditional risk assessment model of three lines of defence, which are;

Line 1 - Operational, risk management and quality controls.

Line 2 - Quality assurance, risk management, validation and compliance testing.

Line 3 - Internal audit.

The focus of the report was on internal audit and therefore the other two lines of defence were not discussed, although the role of internal audit in relation to the other two lines was mentioned, as part of their audit and oversight function.

“Additionally, regulators have expressed that independent testing of the BSA/ AML and OFAC programs must improve, and they expect internal audit departments to provide a more robust third line of defence at the nation’s banks.”⁸²⁷

However, despite the requirements and vision for internal audit, PWC reported that on the whole the skills within internal audit generally

⁸²⁵ PwC, (2014) Internal audit holding the line on BSA/AML compliance. Available at: <http://antimoneylaundering-fiba.com/files/1499.pdf> accessed 30 March 2015 p11

⁸²⁶ PwC, (2014,p3)

⁸²⁷ PwC, (2014) Internal audit holding the line on BSA/AML compliance <http://antimoneylaundering-fiba.com/files/1499.pdf> accessed 30 March 2015 (p3)

were not able to deal with these new expectations “*Internal audit’s assessment of AML risks and audit planning processes are insufficient to develop an effective testing plan and typically do not leverage data analytics to better focus on the risks.*”⁸²⁸

The main gaps in audit function for AML compliance testing were: insufficient data testing and not commensurate with AML risks; lack of data analytics in testing; insufficient risk assessment and AML planning; and finally, a lack of knowledge of AML risks within the audit sector.

5.8.9 Commentary on the Report

The PWC report reiterates the standard model for risk assessment with the assumption of three lines of defence against money laundering, and it does not challenge this approach at all. However, one of the weaknesses of this model is that if a knowledge gap exists at each line of defence then the vulnerabilities become similar to those in the Swiss Cheese theory model ⁸²⁹ which is often used in policing and accident risk assessment; whereby each line of defence has its own weaknesses like holes in slices of Swiss cheese, the vulnerabilities are not a problem until they are aligned like lining up the holes in the slices of cheese. In this case the knowledge gaps could provide a major vulnerability that cuts across all the lines of defence thus exposing the entire banking operation to money

⁸²⁸ PwC, (2014,p7)

⁸²⁹ Reason, J. (1990) Human Error. Cambridge: University Press, Cambridge

laundering risk. Therefore, strengthening internal audit is one component of the operation, but it is also imperative that each of the other lines of defence are strengthened as well. Ideally perhaps internal audit should be used to ensure that the first two lines of defence are operating effectively rather than using IA as a safety catch, one that currently appears to have very big holes in it.

Another option would be to consider a more holistic model of risk assessment that encouraged a culture of AML compliance and risk containment across all units in the bank, instead of relying on certain units such as AML compliance and assuming that they would respond to all the issues.

5.8.10 Financial Conduct Authority

The Financial Conduct Authority produced a report in 2013 which was a review of banks risks to trade finance. The methodology included visiting 17 banks of a variety of sizes and they focused on risk assessment processes including policies and training material.

“We aligned our review with the scope of the Wolfsberg Trade Finance Principles and looked specifically at the mechanisms used to finance the movement of goods and services across borders. Our focus was on Documentary Letters of Credit (LCs) and Documentary Bills for Collection (BCs), where trade-related documents (invoices, bills of

lading, etc.) are routed through banks and examined for consistency within the terms of a trade transaction.”⁸³⁰

Their findings highlighted a number of weaknesses in the AML regime in relation to identifying trade risks, these included an inconsistent approach to AML compliance, which tended to focus specifically on ensuring compliance rather than assessing for money laundering risk.

“We found an inconsistent approach to risk assessment. While a few banks had conducted a discrete trade finance AML risk assessment, and kept it up-to-date, others had not. And we found that banks tended to have a more sophisticated, and better articulated, approach to managing the risk of sanctions breaches, than to managing money laundering risk.”⁸³¹

In terms of specific TBML policies these were largely non-existent or very weak, which tended to mean that lines of responsibility and communication channels were also weak, again highlighting vulnerabilities that cut across all three lines of defence.

“However, we were concerned that the majority of banks had no clear policies or procedures for staff to follow when

⁸³⁰ FCA. (2013). Bank's control of financial crime risks in trade finance. London: Financial Conduct Authority. P7

⁸³¹ FCA. (2013,p13)

*assessing money laundering or terrorist financing risks in trade finance.*⁸³²

The FCA review focused largely on trade finance documentation and found that for banks issuing letters of credit, then due diligence and appropriate AML checks were nearly always undertaken. Letters of credit were rarely if ever given to unknown customers, and most had an established relationship with the bank. Finally, the review identified its own list of red flag indicators that were categorised under five main headings, these were:

- Customer,
- Documents,
- Transaction,
- Payment,
- Shipment.

The review concludes with examples of good and poor practice for TBML detection, where the overarching theme across both sets of examples is the need to screen specifically for financial crime risks and to have clear policies and lines of responsibility in place for this. There is little doubt that the examples of good practice involved a significant resource investment both in terms of training and ongoing staff time to undertake the work at the level of detail suggested. There is a note to companies in relation to considering the examples, which encourages business to

⁸³² FCA. (2013, p15)

consider the size of their own company in relation to the risk exposure they are likely to experience, *“This includes taking into account the size, nature and complexity of a firm when deciding whether a certain example of good and poor practice is appropriate to its business.”*⁸³³

5.8.11 Commentary on the Report

One of the criticisms of the report is the lack of specificity in relation to which banks were compliant and promoting good practice and which were not. There were some very good models that could be followed and also some very worrying non-compliance issues raised. A few statistics to state the percentage of banks largely compliant versus the number that were not would have given a stronger context to the research. Similarly, it would have been useful to have the size of banks and their work at a global level versus compliance and models of practice, which would also have indicated at what level AML compliance was being implemented and where gaps in the system might need to be addressed.

In an interview with John J Byrne executive vice president of ACAMS, the following statement was made regarding the media coverage of suspected money laundering compliance failures at Capital One Financial Corporation.

⁸³³ FCA. (2013). Bank's control of financial crime risks in trade finance. London: Financial Conduct Authority. P42

*"It could be something as simple, but still serious, as compliance deficiencies, like they didn't file reports on time because they had so many. Money laundering is very broad, so it's hard to tell from the regulatory filing. In most cases, it is not intentional money laundering. My educated guess is that it's something with systems or policies."*⁸³⁴

AML compliance is ultimately all about systems and policies so his statement does not really shed any light on anything new there. However, declaring that something can be '*not intentional money laundering*' is an interesting statement and it would be interesting to know what activities would be classified under this heading?

5.8.12 HBUS Risk Assessment Profile

The risk assessment approach adopted by HBUS was fundamentally flawed in a number of ways.⁸³⁵ The case has been discussed in detailed in section 3.6.1 through to the end of the chapter The AML framework that was in operation consisted of a strategic level and an operational level. There were errors in both areas. However, the errors at the strategic level had the greatest impact; because they effectively stopped the operational work being carried out. Brief analysis on such a

⁸³⁴Holan, M (2015) What exactly does an anti-money laundering specialist do? We asked an expert <http://www.bizjournals.com/washington/blog/2015/02/what-exactly-does-an-anti-money-laundering.html?ana=lnk&page=all> accessed 7 March 2015

⁸³⁵O'Brien, J., & Dixon, O. (2013). Common link in failures and scandals at the world's leading banks, the. *Seattle University Law Review*, 19, 941-972

strategic decision can look at models behind the choices made. An example of a model that is beneficial in determining behavioural outcomes is below by Cornish and Clarke.

Based on the decision making model presented by Cornish & Clarke,⁸³⁶ where $B=f\{P.S\}$, and decision behaviour (B) is influenced by Personality (P) and Situation (S). A similar equation of risk could be applied using the model $B=f\{CA.S\}$ where CA is the Corporate Attitude of the bank and S is the AML situation or problem being presented. In HBUS the CA was determined by a number of factors including a focus solely on the legal risks that ML presented to the bank, a lack of resources given to the AML Director and the misclassification of AML risks as client risks rather than banking risks.

CA = AML low level of priority x minimal pressure from OCC x lack of clarity from internal audit.

S= Alerts rising above 17,000 (seen as administration issues).

B= Short term input of resources.

The board agreed to short term injections of resources in response to unwieldy administration problems, rather than classifying the problem as a major AML concern. Therefore, strategic decisions at the governance level appeared to have been influenced partly by resources and also by the absence of a strong argument made by the audit committee and

⁸³⁶ Cornish, Derek B, and R V G Clarke (eds). *The Reasoning Criminal: Rational Choice Perspectives on Offending*. reprint ed. Transaction Publishers, 2014.

internal audit to address the areas of AML concern. As the pressure increased from the regulator (OCC), additional resources were identified and made available and the concerns and priorities of AML began to be addressed.

5.8.13 HSBC Switzerland Risk Assessment Profile

In the HSBC Swiss case the equation could be applied as follows;

CA= Acceptance of clients regardless of CDD concerns.

S= Incomplete customer profiles and CDD checks.

B= High risk acceptance of criminal clients who subsequently used the bank to evade tax and launder money through the system.

This case therefore has repercussions for all the banking sector since it actually provides a legal ruling outlining the responsibilities of the bank, not just to the regulator in terms of AML compliance, but also to their clients and business partners that the bank works with.

5.8.14 Conclusion Secondary Data

The secondary data sources were chosen because of their empirical research and related findings from various case scenarios. These organisations all had access to data that this research was not able

to access, such as ongoing legal cases, and access to the reports generated through the banking sector. In addition, public media cases involving AML compliance failures were used and analysed in order to establish if there were any legal findings relevant to this study. The combined secondary data has been used to form a contextual framework in which the primary research data can be analysed. This will enhance the credibility of the research in terms of making recommendations and generalisations by providing a broader selection of data.

One of the criticisms that was identified in the literature review, and which was also raised as an issue in the primary data results, was that many of the guidance documents and red flag indicators for money laundering are too generic and lack specificity. The banking sector is asking for more detailed examples of risk assessment models and guidance resources, which can provide a greater level of awareness. This research has sought to access as much detailed information as possible, given the legal constraints and issues of confidentiality that affect the study of this topic, in order of developing a risk assessment model that can give more specific guidance for TBML transactions and which can be used for general money laundering risk assessment as well.

CHAPTER 6 FINDINGS

6.1 Introduction

The findings section highlights what has been discovered through the research process and links together the data analysis, literature, reports and theoretical analysis. It links the findings back to the original research questions that needed to be answered, and see whether this has been achieved.

This section has been divided into two main parts whereby the first part has been presented to answer the main research questions listed below.

1. What is trade based money laundering and how does it manifest within a global banking context?
2. How do criminals wishing to manipulate banks for TBML gain access to the financial services they require?
3. What tools are currently used in TBML risk assessment in banks, and what are the strengths and difficulties associated with these?
4. What models of risk assessment / control framework can be developed for TBML?

The second part of the findings section focuses on determining whether a specific risk assessment framework could be developed that would be cognisant of the information gathered from across all the various

data sources. In particular, as part of questions 3 & 4, the researcher wanted to consider if a risk assessment framework needed to be developed specifically for TBML, or whether a generic financial crime framework could be developed that would incorporate a number of financial crime risks. This was followed by a second interest area which was to consider what implications this risk framework would have for the role of the internal audit function (traditionally viewed as the third line of defence in most standard risk assessment processes within the banking structure). Initial analysis from the data implied that TBML and ML audits were separate processes to the actual risk assessment process.

The second part of the findings section has therefore been sub divided to cover these two main sub topics, namely of TBML risk assessment and TBML / ML risk audit processes. Together these two components are expected to form part of an overall risk assessment framework for TBML that can be applied to the banking and financial services sector.

6.2 Research Questions

Q1 - What is trade based money laundering and how does it manifest within a global banking context?

Trade-based money laundering has been recognised by the Financial Action Task Force (FATF, 2008) as a serious threat to the formal financial services, since it views the misuse of the trade system “as one of

the main methods by which criminal organisations and terrorist financiers move money for the purpose of disguising its origins and integrating it into the formal economy” (p3). In simple terms money is often converted into a trading commodity and shipped across different jurisdictions, from where it can be converted into whichever currency is required, these transactions can then be presented as a legitimate business exchange. Despite the simplicity of the definition, the money laundering schemes used to move the goods can be highly complex and involve multiple jurisdictions and the use of different financial services.

The banking sector often becomes involved in these transactions through their trading finance services, which uses an array of documentation, much of which can be forged through using false identities, shell companies, front businesses and falsified shipping and invoicing documents. In addition to difficulties in verifying trade and shipping documentation, the ports of origin and destination can be misdirected through the use of free trade zones.⁸³⁷ Finally, given the complex nature of the business transactions and in order to accurately assess and verify each business and trading transaction, a number of agencies including customs, revenue, law enforcement as well as the banking services would need to co-operate together on a regular basis.

⁸³⁷ FATF (2010) Money laundering vulnerabilities of free trade zones. France: Paris: FATF/OECD. <http://www.fatf-gafi.org/media/fatf/documents/reports/ML%20vulnerabilities%20of%20Free%20Trade%20Zones.pdf> accessed 28 July 2015

Q2 - How do criminals wishing to manipulate banks for TBML gain access to the financial services they require?

The research considered a number of scenarios and typology studies⁸³⁸ that provided detailed insights into how criminals were accessing and using the financial services system. A number of factors emerged that have implications for risk assessment processes, in particular many of them concern the verification of the client and the source of their business funds. The main categories of findings include the following;

- The first point is that given the complexity of many TBML schemes, in many cases criminals need to co-operate together in order to access the financial services. Schemes that involve the falsification of invoices in particular, require both trading parties to agree on the scheme, other examples of criminal co-operation include;
 - Structuring funds through an account using different people and accounts.
 - Using free trade zones to disguise shipping destinations.
- A second challenge for criminal launderers is that many financial services and banks already have in place basic customer due diligence systems that first need to be bypassed. This has created a situation whereby criminals have sought to acquire an easier

⁸³⁸ FATF. (2008). Best practices paper on trade based money laundering. Paris: FATF/OECD. Available from: <http://www.fatf-gafi.org/> [accessed 11th May 2015].
AUSTRAC (2014) Typologies and case Studies Retrieved from <http://www.austrac.gov.au/sites/default/files/typologies-report-2014.pdf>

access route into the banking system without attracting attention. One of the ways that this can be achieved is by using existing customers who have already cleared CDD checks. Other examples of bypassing CDD checks include;

- Using accounts of family members or associates to move money through.
 - Using off shore accounts and shell companies.
 - Hacking accounts and mirroring other business transactions (cuckoo smurfing).
- Another challenge for the banks is to verify and authenticate the goods, that many criminals are trading in. Some commodities such as diamonds are difficult to value and have become a useful tool for money launderers to move.
 - The final challenge is for banks to verify the source of the funds being used to finance the business. There have been cases such as the HSBC Swiss bank whereby clients had acquired money from sources of bribery and corruption, as well as predicate offences such as smuggling and art theft.

All of these factors highlight the level of imagination that criminal schemes are able to implement, and many of the schemes appear to have been developed in response to increased AML controls and stricter customer verification checks. However, one of the difficulties is that as money laundering schemes evolve to counteract the larger banking responses to AML detection, these then place additional pressures on

smaller banking systems of which are located in more vulnerable and weakened economies and are less able to deal with these complexities. These vulnerable systems have the potential to become entry points for money launderers through which to move funds into the larger financial banks and services in countries with stricter and more developed AML checks. Therefore, a global response to AML regulation and control needs to be pursued in order to effectively protect the whole banking sector.

Q3 - What tools are currently used in TBML risk assessment in banks, and what are the strengths and difficulties associated with these?

TBML risk assessment has been traditionally focused on the trade finance units of the bank as well as AML compliance, but the findings from this research and other case studies of TBML activity, imply that the money laundering activities will cut across all areas of the bank. In particular, TBML can affect or be detected by any staff member involved in customer interaction, business units, trade finance, audit, training and the allocation of resources. Although TBML compliance and other AML compliance systems may be currently used as one system within a bank, there are several main areas of consideration that relate specifically to TBML transactions which need to be included within a risk assessment framework for trade related money laundering activity. These differences also need to be considered in light of other noted weaknesses within generic money laundering risk assessment models, so that all the gaps can be plugged at one time.

6.2.1 Weaknesses in Risk Assessment Models

There are a number of weaknesses inherent in any risk assessment model, but the biggest weakness in money laundering risk assessment is underestimating the impact that it has on the client and the business focus of the bank. Many of the difficulties highlighted in recent cases including HSBC in the US, have arisen as a result of trying to quicken up assessment processes for the client, for example overriding the OFAC filters. In order to provide an effective business service to clients and for clients to understand the money laundering risk process, there is the need for a clearer system of communication between bank and client. This system should aim to facilitate the business focus of the client whilst not expose the bank to an increased AML risk, due to a lack of adequate risk assessment processes. Obviously, this also has a downside because the more information you provide to the client about risk assessment, then the more information you are effectively also giving to the criminal to circumvent the system.

6.2.2 Information That the Client Needs To Know

In a more stringent AML regime the client can also be an ally in risk assessment processes, especially if they are prepared beforehand and can supply the information required. In order for that to occur, the client

needs to be aware that the following areas will be assessed and hence potentially take time.

1. *Geographical profiling and client partners are also under assessment* - Confidentiality can operate both ways in that clients do not necessarily need to be aware of all these checks until they are seeking international trade finance. Before submitting an application, they should be advised that they will need to provide information to comply with BOI and EDD checks depending on the nature of the business. The results of the risk assessment profiling do not need to be shared with the client, but the questions giving rise to any concerns do need to be asked of the client.

2. *Complete list of information needed for clarification*

- A complete list of documentation required should be provided to the client rather than a drip response of needing one piece and then after submission a second piece. This can cause unnecessary delays and frustration.

Although information can also enable criminals to prepare ways around the system (they will do this anyway), the aim is also to encourage businesses to become more aware of their own risks and exposure to money laundering activity. The bank also has a responsibility to the client to ensure that their business and account are not being used without their knowledge for fraudulent activity. Checks still need to be stringent even if the client presents all the paperwork, However, not knowing which paperwork to present is not an efficient part of risk assessment.

6.2.3 Front and legitimate companies

The use of front companies or legitimate clients has been proved, through the sanitised case studies⁸³⁹ to provide an effective entry route into the banking structure and to enable criminals to comply with CDD and KYC checks. The implications of this in terms of risk assessment indicators mean that;

1. A system for routinely monitoring low risk clients may be needed since these will be potential targets for criminals, especially if there are family or business links to criminal groups. This monitoring process could be computerised or automated to spot unusual transactions and changes in business practices / business partners or third party involvement in the business.
2. Beneficial ownership checks are becoming of increasing importance since the client presenting the business plan may not be the beneficiary of the business. In particular, family members may undertake CDD checks instead of members with known links to criminal activity.
3. Monitoring family member accounts especially those of politically exposed persons could become a requirement after identifying

⁸³⁹ FATF. (2008). Best practices paper on trade based money laundering. Paris: FATF/OECD. Available from: <http://www.fatf-gafi.org/> [accessed 11th May 2015].

suspicious client behaviour or high geographical risks for certain clients.

6.2.4 Geographical Risks

Geographical risks are an important consideration in any risk assessment model. These include an awareness of sanctions against certain countries and / or product sanctions within certain countries:

1. These can also include developing an awareness of illicit financial flows moving from developing countries into developed economies.
2. Movement of funds from developed economies to high risk countries known to support terrorism.
3. The use of free trade zones to mask the final destination country being a potential problem, that needs to be explored as much as possible.
4. Certain countries have been highlighted through UN reports for being vulnerable for smuggling such as diamonds or endangered wildlife; these should be used as part of the geographic risk assessment process.

6.2.5 Trade Patterns

Trade risks remain a priority as they become the more mainstream way of moving products and cash from one jurisdiction to another, often as part of complex criminal financial networks:

1. Traditional trade red alerts including over and under invoicing, falsified shipping documents and the use of free trade zones to hide entry ports are all factors that need to be monitored or detected.
2. Financial crime risks need to form the basis of a risk assessment framework. This framework needs to incorporate the links between the various different financial crime risks of tax evasion, capital flight, TBML and corporate fraud.

6.2.6 Technology

Technology and the related skills of data analysis need to be incorporated as and when appropriate, into the risk assessment model. However, this software and data use needs to become more specific to complex money laundering schemes, including the use of trade and shipping, rather than being too generic and only focused on simple cash based ML schemes.

There is still a dearth of software that can be used in banking to support AML compliance, however, some work has been done especially in the US. Certain models such as trade transparency units have established a method of sharing information across different agencies.

Since a lot of shipping routes pass through or include the United States then these data bases are of use even within the European or Asian / African banking sector.

6.2.7 Training and Resources

A primary concern raised by many of the respondents, and named as a key area of weakness, was the overall knowledge base of the staff involved in risk assessment. This concern included all front office staff and those interacting with clients, as well as audit and AML compliance staff. At a basic level if there is limited awareness of the types of fraud that clients can be involved in, then detection of such schemes will become very difficult. The knowledge required amongst all staff would include the use of falsified documentation, using front businesses and hiding behind family members' accounts. At the stage where suspicions have been raised, there then needs to be a clear system for reporting this information to those staff involved in anti-money laundering compliance. In turn this information also needs to be reported to those units within the bank that may be involved in other aspects of the client's business and finance arrangements.

The main problem associated with increasing knowledge and expertise is that it requires an investment in training. However, external training agencies, which tend to be the major expense, can also be supported through in house training and peer information sessions. Another way of supporting the training information is to encourage staff to participate in regular exchanges and meetings with staff in different units in the bank, with a focus on money laundering. This could also allow for the development of local typologies and sharing of suspected problems or

weak areas in AML compliance. A combination of these different methods could be used to develop and identify the potential ML schemes that could work in the bank, as well as aiding in the analysis of weak entry points into the bank's structure. Finally, the knowledge base needs to extend across all levels of the staffing structure through to the management level. This is to ensure firstly that there is a clear understanding of the resource requirements and training needs, and also secondly to understand the implications of any audit reports which may be used to highlight weaknesses in the AML processes and structure being implemented. Throughout the development of an effective AML system training is a vital component for developing the human component of TBML detection, and ultimately reducing the bank's exposure to financial crime risks. At the very basic level this training needs to be:

1. Appropriate to include all staff at the basic level and then tailored to the specific skills of staff who are involved in client's accounts.
2. Practical so that staff can relate to its relevance in their work.
3. It needs to be regularly updated and to use current models and examples of known and reported ML / TBML activity.

6.2.8 TBML Auditing

One of the findings to emerge from the research, or to gain clarity in significance, is that AML auditing and AML risk assessment are separate processes. One of the areas that respondents failed to reach a conclusive

agreement on was to clarify how the role of auditing and compliance link or interlink for AML systems. The model of internal audit holding the third line of defence has still to be challenged effectively within the banking domain, and so this model continues to permeate and direct auditing responses. However, many empirical studies were clear to highlight that auditing skills are still lacking in this area. In particular, the research found that specific audit skills need to be developed which can be focused on financial crime auditing including TBML audits:

- These can consist of being able to effectively assess the suitability of risk approaches being used in the different units, and
- Can also assess the efficiency of the overall system for communicating risk assessment findings across the entire bank.

In the discussion so far, a number of areas have been highlighted. Some of these themes relate directly to developing risk assessment processes and some relate to the overall risk support framework that is needed to ensure that risk assessment remains effective and up to date. The next section of the report focuses on the development of an overall framework for risk assessment and TBML within the banking context. It has then developed this framework into a practical tool to assist risk assessment processes within banking, that can be used by any staff, at any stage of a reviewing a client's account or business.

Q4 - What models of risk assessment / control framework can be developed for TBML?

The fourth research question focused specifically on the theoretical and empirical implication findings in relation to developing a risk assessment model. One of the key points that arose from the HSBC cases, as well as also arising in the comments from participants, was that a simple risk matrix that just followed a series of check boxes was not an effective approach. In particular, it would not suffice in combating the serious criminal misuse of trade finance, that was currently occurring through the banking sector. FATF in their 2006 and 2008 reports⁸⁴⁰ advocated a more dynamic risk approach that could respond to different ML scenarios as they emerged, although a model that was too complicated would not be practical to implement either.

In this section the researcher has devised a risk assessment framework in response to the issues raised throughout the research data and literature analysis. In particular, the assessment framework responded to the following issues that were highlighted by participants:

- The risk model should be designed to ensure that a minimum base level of staff training and competence levels in TBML detection is in place.
- There should be an assumption that resources will be made available and a commitment made at senior level to developing TBML risk processes.

⁸⁴⁰ FATF. (2008). Best practices paper on trade based money laundering. Paris: FATF/OECD. Available from: <http://www.fatf-gafi.org/> [accessed 11th May 2015].
FATF. (2006). Trade based money laundering. France. Financial Action Task Force.

- Existing guidelines and red flag indicators from key FIU reports and FATF on TBML should be utilised.

This project is suggesting that there are three separate but interlinked elements to risk assessment:

1. A risk framework and within that
2. A risk assessment process and
3. A risk audit process.

6.3 Risk Assessment Framework

The risk assessment framework involves all areas of the bank including governance and audit committees. It has been sub divided into three tiers, that each work in tandem with each other, to ensure that the model operates most effectively. The aim of the framework is to develop a culture of proactive AML detection and the prevention of any type of financial crime. The three tiers of framework are:

- Tier One - Resources and Governance.
- Tier Two - Risk Assessment Matrix – including research and technology.
- Tier Three - Risk Auditing for TBML.

6.3.1 Tier One - Resources and Governance

The first tier in the model arose out of responses from the research participants who stated that for any risk assessment framework to be effective there are two things that they identified as being crucial. The first was the need to have adequate access to resources, which also includes appropriate staff skills, time and training. The second and perhaps most important point was that there needed to be support from the top of the governance structure and this needed to infiltrate through the entire organisation. These two points have been described in more detail below before moving onto the other elements of the risk assessment framework.

6.3.1.1 Resources and training

One of the findings of the research is that risk assessment processes cannot operate in isolation. In particular, underpinning any effective risk assessment model is that there has to be a commitment to provide appropriate levels of resources and training, which are tailored towards equipping staff with the AML tools being developed. One of the biggest challenges for those responsible for resource allocation, is the reality that most banks are under business pressure to produce profit, this means that inevitably cost centres such as AML compliance are not usually the first priority for resource allocation. Although increased pressure from regulators may be perceived as one way to elicit extra resources, a more sustainable approach would be to develop a more

efficient system within the bank; one that is supported by governance and meets the needs of the bank's own business strategy. The tool proposed in this project was especially mindful of the fact that allocating huge resources was not an option for many of the smaller banks and other financial services.

The other challenge that most banks face when considering or developing AML training programmes, is the need to develop an AML tool that can be utilised by all staff, regardless of their existing level of expertise in trade finance or international banking. Again this suggested that a simpler tool was required that could encompass many of the requirements of a responsive risk based approach. However, one of the benefits of rule based approaches and tick box checklists, is that they can act as a guide for staff. Therefore, if a risk based model could be developed that retained this added level of guidance and support by utilising the checking process, then this could enhance the model and be used across all the staff teams, without incurring a large training budget or developing only a few core specialist staff.

6.3.1.2 Governance

The role of governance has been highlighted by many of the respondents in the survey and interviews, as being vital to the success of any AML / TBML risk assessment process. It was also highlighted as an area of major weakness in some of the cases such as HSBC where ML

controls failed to identify risks from clients and audits did not report effectively on the low levels of AML compliance. In the HBUS case the regulator also came in for criticism because they did not provide enough guidance to the management structure and did not highlight the risks that the banks was being exposed to.⁸⁴¹

The governance structure within the bank can be responsible for making fundamental changes in behaviour and attitude amongst the staff, especially in the corporate attitude and cultural practices associated with AML compliance. The HSBC Swiss bank case suggested that the bank's corporate attitude was to support clients to evade tax requirements and to use the formal financial sector and existing international practices to achieve this.⁸⁴² If future AML strategies are to be effective and implemented across all units within the bank, then the corporate attitude towards money laundering and financial crime also needs to reflect this new approach.

One of the pillars of governance that requires a change in role is the internal audit function. This function is responsible for providing a link between the practice happening in the bank units and reporting the weaknesses in this structure to the audit committee / management. Many of the empirical reports on money laundering, that this research project

⁸⁴¹ Homeland Security. (2012). HSBC exposed US financial system to money laundering, drug, terrorist financing risks. From permanent sub committee on investigations. US Senate. Retrieved from <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/us-vulnerabilities-to-money-laundering-drugs-and-terrorist-financing-hsbc-case-history> accessed 4 August 2015

⁸⁴² ICIJ (2015) Swiss leaks: Murky cash sheltered by bank secrecy <http://www.icij.org/project/swiss-leaks/banking-giant-hsbc-sheltered-murky-cash-linked-dictators-and-arms-dealers> accessed 2 March 2015

considered tended to focus solely on the AML compliance and risk assessment processes. The other role of governance is to ensure that adequate AML audits are carried out that can analyse the use of resources, and the success of the system being used, including the relevance of the risk assessment processes and the effectiveness of the reporting structure to the financial intelligence unit. For this reason, AML compliance should be considered as part of an overall AML risk framework that includes each of these different components of risk assessment, risk audit and compliance requirements.

6.3.2 Tier Two - Risk Assessment Matrix

Tier two of the risk assessment framework is the actual risk matrix. This model builds upon existing risk assessment matrices currently in use within the banking sector. In this research the proposed model is a simple matrix comprising of four areas of risk assessment that have designed to be made into a visual representation of the client risk. The model was influenced by statements from respondents in the research, as well as the literature, which referred to the FATF indicators⁸⁴³ as well as other red flag alerts of money laundering activity such as the AUSTRAC reports⁸⁴⁴

⁸⁴³FATF. (2013). "Methodology FOR ASSESSING TECHNICAL COMPLIANCE WITH THE FATF RECOMMENDATIONS AND THE EFFECTIVENESS OF AML/CFT SYSTEMS". FATF, Paris, France. Available at: www.fatf-gafi.org/media/fatf/documents/methodology/FATF%20Methodology%2022%20Feb%202013.pdf

⁸⁴⁴ AUSTRAC (2014) Typologies and case Studies Retrieved from <http://www.austrac.gov.au/sites/default/files/typologies-report-2014.pdf>
AUSTRAC. (2013). Typologies and case studies report. Australian Transaction and Analysis Centre. Retrieved from http://www.austrac.gov.au/sites/default/files/documents/typ13_full.pdf

and the APG report⁸⁴⁵. One of the problems that the researcher noted was that red flags are usually presented in these guidelines and reports as one long list with no classification or sub themes. In this research the indicators or red flag alerts have been grouped under four main headings, which the researcher believes covers all the themes raised by participants and the various typology reports that have been reviewed. This risk assessment tool is designed for use against all types of financial crime, including TBML and uses the following four headings;

- Geographical risk
- Client Behavioural risk
- Client Transaction risk
- Client Partner or Third Party risk

These four headings encompass all the core themes that the experts and the questionnaire results identified as being paramount to trade-based money laundering detection. As part of the design process the generic FATF indicators for TBML activity have been reclassified using these same four headings to ensure that everything can be covered in this format. As a further exercise following the descriptions, the research has also taken the main indicators identified by AUSTRAC (2014), the Australian Financial Intelligence Unit, and these have also been reclassified to illustrate how all the indicators regardless of the area of

⁸⁴⁵APG. (2012). APG typology report on trade based money laundering. Retrieved from http://www.fatf-gafi.org/media/fatf/documents/reports/Trade_Based_ML_APGReport.pdf

money laundering can be sub divided into these four categories. As well as providing a risk assessment framework this model can also be used as a training tool to help explain and develop a better understanding of TBML risks. Underpinning the framework and the four key elements is always the need for governance support for the model, and emanating from this are the assurances of adequate and ongoing training and resources.

6.3.2.1 Geographical Risk

The nature of global banking means that every client involved in shipping and trade is potentially engaged in business with another country, and therefore the bank is at risk of providing money either directly or indirectly to countries that are blacklisted, or supporting the entry of products that are blacklisted by those countries. In order to mitigate against this risk an element of geographical risk assessment is incorporated so that the client and the bank can identify the extent of this risk. If required, further clarification and documentation may be required by the business to assure the bank that the client's business is not connected to any international criminal smuggling trade, such as illegal arms trafficking, human trafficking or goods smuggling including using goods to launder money. According to FATF some indicators or red flags for geographical risk in TBML include;

- The commodity is shipped to (or from) a jurisdiction designated as "high risk" for money laundering activities.

- The commodity is transhipped through one or more jurisdictions for no apparent economic reason.

This is probably the area of greatest change for bank's risk assessment processes. It does involve more research initially but obviously once a country has been researched then that information can be used with all clients involved in trading in this region. Research also needs to be ongoing to monitor media and other reports such as UN updates on products or countries at civil unrest. However, it is no different to traditional risk research into companies and investment options, the focus of the research is slightly different and would need a researcher competent in financial risk analysis. Alternatively, certain Financial Intelligence Units⁸⁴⁶ may already collate some of this information and it could be made available to bank research units (or trade finance units) as required.

6.3.2.2 Client Behavioural Risk

Client risk has tended to focus on obvious data verification methods such as establishing identity and credit history. However, many clients are either using falsified documents or using legitimate clients and businesses as fronts for their criminal activities, therefore standard CDD checks are

⁸⁴⁶FIU Netherlands. (2015). FIU Netherlands annual report 2014. FIU-the Netherlands. Retrieved from https://www.fiu-nederland.nl/sites/www.fiu-nederland.nl/files/documenten/5276-fiu_jaaroverzicht_2014-engelsweb2.pdf
ctif cfi. (2013). Belgian financial intelligence report. Brussels. Annual Report. Retrieved from http://www.ctif-cfi.be/website/images/EN/annual_report/ar2013.pdf

not necessarily picking up on this level of fraudulent behaviour. Suspicious behaviour such as making multiple deposits into different branches, evading verification checks and being reluctant to provide information on clients or business partners are all indicators of suspicious behaviour that needs to be documented. Front office staff who deal with customers are often most likely to witness any of these behavioural traits and therefore a system for filing alerts internally at this level would need to be developed. FATF indicators for suspicious client businesses and types of commodity being shipped that they designate as “high risk” for money laundering activities include the following indicators:

- The size of the shipment appears inconsistent with the scale of the exporter or importer’s regular business activities
- The type of commodity being shipped appears inconsistent with the exporter or importer’s regular business activities
- The shipment does not make economic sense
- There are irregularities in the trade documentation being provided
- Significant discrepancies appear between the description of the commodity on the bill of lading and the invoice
- Significant discrepancies appear between the description of the goods on the bill of lading (or invoice) and the actual goods shipped
- Significant discrepancies appear between the value of the commodity reported on the invoice and the commodity’s fair market value

- The transaction involves the use of repeatedly amended or frequently extended letters of credit.⁸⁴⁷

Although any or all of these indicators can change as criminals continue to try and work around the AML system, the main pattern is to watch for trading transactions that appear to be overly complex and/or offer a sudden change in normal business practice for this client without a reasonable explanation. This data may not be readily available or understood by front office staff, who are often the staff carrying out CDD and EDD checks. This is a key area for future training within the banking context since understanding how trade data can be manipulated is an essential requirement to stopping or uncovering trade based money laundering techniques.

6.3.2.3 Client Transaction Risk

Transaction risk is the one area where automation and technology may be introduced, to enable computers to trawl through data seeking anomalies or sudden changes in transaction patterns. However, the programmes still need to be informed by human observations and data analytic software needs to be developed specifically to seek out trade patterns that could be risk related. Currently the standard indicators of money laundering activity relate to examples such as the structuring of

⁸⁴⁷ FATF. (2006). Trade based money laundering. France. Retrieved from <http://www.fatf-gafi.org/media/fatf/documents/reports/Trade%20Based%20Money%20Laundering.pdf>

funds through micro deposits to avoid detection. However, finance trade patterns also need to focus on possible under and over invoicing through price misrepresentation activities, and complex financial transactions involving multiple accounts and different jurisdictions. The FATF indicators that apply to this category are;

- The method of payment appears inconsistent with the risk characteristics of the transaction
- The shipment finance does not make economic sense

6.3.2.4 Third Party Risk

This is also a new area of risk assessment and links into the increased focus on beneficial ownership of companies and transactions.⁸⁴⁸ It has become increasingly evident through FIU reports and media coverage of banking cases, that many clients are hiding their trading activity through the use of third party businesses and people. Illicit financial flows from developing countries into the western economies often involve politically exposed persons (PEP). These PEPs know that they will be checked through enhanced due diligent systems and so they use third party members and friends to hide the source of the money. Sometimes criminal organisations will also approach legitimate business owners for

⁸⁴⁸ FATF. (2014). Transparency and beneficial ownership. France: Financial Action Task Force. FATF Guidance. Retrieved from <http://www.fatf-gafi.org/documents/guidance/transparency-and-beneficial-ownership.html>

them to undertake financial transactions on their behalf and avoid CDD checks. This means that the bank CDD process also needs to incorporate the analysis of key beneficiaries within the business and to verify ownership information. It is often through this process that suspicious client behaviour may come to the fore, as the client becomes uncomfortable with the process. The FATF indicators include;

- The transaction involves the use of front (or shell) companies.
- The transaction involves the receipt of cash (or other payments) from third party entities that have no apparent connection with the transaction.⁸⁴⁹

These four areas encourage the risk assessment process to consider four particular aspects of their client's business -

- Where the client is doing business
- Who the client is doing business with
- Whether the transactions reflect a legitimate business
- Whether the client appears to represent a legitimate business.

This is advancement on the traditional model which has so far only considered the legitimacy of transaction patterns and an assessment of the client. The other challenge for risk assessment in banks is that this

⁸⁴⁹FATF. (2014). Transparency and beneficial ownership. France: Financial Action Task Force. FATF Guidance. Retrieved from <http://www.fatf-gafi.org/documents/guidance/transparency-and-beneficial-ownership.html>

two-pronged approach has been undertaken in a vacuum, without understanding the nature of the business and the risks of third party involvements and country risks. The four-pronged model of risk assessment requires banks to undertake greater and more enhanced checks, but to consider them in a systematic way. For example, if the destination country being traded with is low risk, but the goods are being taken through a complicated shipping route then it makes sense to prioritise analysing the route and reasons behind it, rather than undertaking lots of research on risks within the final destination country.

To illustrate this point further at the end of the next section in the findings the researcher has reviewed the indicators of a number of different money laundering cases, as presented by the Australian financial intelligence unit AUSTRAC. These indicators have been categorised under each of the four headings in the risk assessment model as an example of how any indicator can be used in this way. This ensures that the model is constantly evolving and all banks have to do is to keep categorising any additional or emerging indicators into the different themed headings. Although it does not eliminate the problem of enormous lists of red flag alerts it does provide the basis for reducing the amount that have to be searched through at any one time.

6.3.2.5 Risk Matrix

The four headings in the previous section are a useful way to categorise red flag alerts, However, the aim in this risk assessment model is to also assess and record client's overall risk from money laundering. In this case the red flags are used to provide additional information to the bank staff when using the risk matrix.

The risk matrix being proposed in this research is based upon the traditional risk assessment model, which has tended to view client behaviour and account transactions as the two main components in a simple risk matrix. In the traditional model with two axis it produces four possible outcomes of

1. **Low** for both client and transaction risks,
2. **High** for client but low for transaction risk &
3. **High** for transaction but low for client or
4. **Very High** for both client and transaction risks.

However, the research was interested to determine what would happen if this matrix was expanded further to incorporate two additional components, namely geographical risk and client partner or third party risk, this will provide a different style of pattern as shown below. This risk matrix is slightly more complex but will operate along the same kind of principle as the simple matrix.

Table 4: Risk assessment

<p><u>Geographical Risk</u></p> <p><i>Examples of possible questions:</i></p> <p>Is the Client dealing with a country deemed as high risk?</p> <p>Is the client dealing with goods or trades deemed as high risk for the country involved?</p> <p>10 9 8 7 6 5 4 3 2 1</p>	<p><u>Client Behavioural Risk</u></p> <p><i>Examples of possible questions:</i></p> <p>Is the client open and willing to provide information relevant to their KYC and CDD?</p> <p>Does the business proposal make sense in terms of cost, shipping routes, goods / values/ financial requirements?</p> <p>1 2 3 4 5 6 7 8 9 10</p>
<p>10 9 8 7 6 5 4 3 2 1</p> <p><u>Client Partner Risk</u></p> <p><i>Examples of possible questions:</i></p> <p>Are there partners involved and if so is KYC data available for them?</p> <p>Are family members involved in the business, and if so are they resident in different countries?</p>	<p>1 2 3 4 5 6 7 8 9 10</p> <p><u>Client Transaction Risk</u></p> <p><i>Examples of possible questions:</i></p> <p>Does the account receive funds in such a way that they could be structured? (i.e. Money that doesn't equate with the nature of the business - lots of small amounts of cash deposits for large costing items)</p> <p>Is the money making complicated transfer routes and across jurisdictions to the final beneficial owner?</p>

The risk assessment process is undertaken as follows;

- A. In this model a risk rating is applied separately for each of the four areas of the risk assessment model on a scale of 1-10.
- B. This would lead to four separate marks one for each of the four headings, these are then being marked on the matrix.
- C. The next stage is to draw a simple line between each of the four points on the different axis.
- D. This will produce a shape in the middle of the risk assessment matrix around the centre cross.
- E. How far out the shape expands from the centre will depend upon the rating for each sector, so four axis x 10 ratings would be the maximum or very high risk score and would produce a shape covering the four outer sides of the matrix. At the other extreme four x 1 ratings would produce a small square in the centre and most of the matrix would remain outside of this space indicating that it was low risk score.
- F. Depending upon which areas of the graph are showing highest risk this would determine where additional follow up and enhanced due diligence processes need to be applied.

6.3.2.6 Reasons for Developing a More Complex Risk Assessment Process

The risk matrix may on the one hand appear more complicated if banks are only undertaking simple risk matrix testing, or it may seem unnecessarily repetitive if banks have a specialised unit which is currently undertaking in-depth research on individual clients. There are a number of reasons as to why risk assessment needs to evolve within the banking context; firstly, it needs to become more complex in order to capture the increased complexity of known money laundering schemes but also it needs to become more standardised across the different staff undertaking this process in the organisation. Both of these factors are important because of changes occurring within the compliance and regulatory background.

- A. The Financial Action Task Force reports on a country by country basis. Therefore, there needs to be consistency across all banks and financial services within a particular country, to ensure that an adequate and effective national strategy against money laundering is achieved.
- B. As AML systems evolve they are becoming the responsibility of all staff within a bank and therefore there needs to be an accountable and transparent approach taken that all staff can follow.
- C. There is a challenge in trying to marry consistency along with flexibility and so a model needs to be used that enables additional

indicators and knowledge to be added to the system, without undermining the consistent approach.

- D. Justifying the use of dedicated resources on risk assessment and research will need to be illustrated in AML audits, and so the model needs to clearly outline why and how additional due diligence steps were agreed upon and what evidence underpinned these decisions.
- E. Suspicious reports need to be filed with the national FIU, but these need to be evidence based and should justify why the FIU should spend more resources and possibly delay client's business dealings investigating cases further. One of the downsides of increased regulatory pressure has been the over reporting of cases that could have been investigated within the bank.
- F. AML audits should be able to analyse the trail of investigation and determine whether the model is effective and where the gaps exist in the system. They also need to make clear evidence based recommendations to governance, of areas that can be fixed or amended with additional training, resources, or changes in banking communication systems etc.

In essence the banking approach to AML compliance needs to become more manageable and integrated into the other main stream banking systems. In order for this to be achieved the AML system needs to be both simple and yet fit for purpose. One of the most important components of this risk assessment system is that staff are trained in and have the access and use of resources such as research material, databases and

specific IT systems. These resources will all enhance the quality of material and information that the risk matrix is using, the better informed the staff are, the more effective the risk matrix system will become.

6.3.3 Tier Three - Research and Technology

The final tier of the framework is the research and technology layer. This tier recognises that a simple matrix of tick boxes will only ever provide a basic overview of the potential risk that a client poses, and a fuller picture will always be needed. The risk matrix designed in this research provides greater insight into four main areas that need to be considered or prioritised in follow up research. In order to strengthen the impact of the risk matrix the high points and very high risk scores will possibly need further research, and this can be done using the four main headings depending on which areas have flagged as potential risk.

6.3.3.1 Research Sources

For each of the four areas on the matrix there are a number of follow up research approaches that can be used, examples for each of the headings are highlighted in the following section but these are not exhaustive by any means. Some of these areas may also require links to other external agencies such as customs, revenue, law enforcement or the national financial intelligence unit.

- A. *Geographic Risks* - media searches for conflict areas, UN reports for war areas, piracy, political instability and increased use of illicit financial flows.
- B. *Client Risks* - research into business background and previous businesses owned. Media coverage on criminal cases client has been involved in, company director register, political relationships, links to countries of political or economic instability.
- C. *Transaction Risks* - transaction history, previous suspicious transaction patterns, average turnover, use of international transfers, history of using alternative remittance systems or other financial services.
- D. *Third Party Risks* - family members or friends involved in businesses connected to the client, family members as beneficial owners to any of the businesses named by the client. Family living or working in jurisdictions blacklisted by the bank.

Some of the research can be enhanced by the use of technology such as in the examples provided below.

- A. Online research and access to media coverage, reports and other publicly available documentation on the economic and political situations of countries, that clients are involved with either personally or through their business.

- B. Big data programmes to analyse simple transactions patterns that could be deemed as suspicious given the nature of the client's business.
- C. Trade data programmes to compare costs of goods around the globe to estimate the viability of the business proposal and trade finance packages being provided through the bank.
- D. Email support to third party agencies to seek clarification on details, rather than launching directly into filing a SAR which could be too vague at this stage.

6.3.3.2 Advantages of the Revised Risk Matrix Model

Despite the simplicity of risk matrix models it is a system that many people are familiar with, who are working within the sector. This also has the added advantage that it is a tool that can be utilised easily and without intense additional training. The two additional categories of risk assessment geographical risk and third party risk add to provide a fuller picture of all of the factors involved in complex ML and TBML activity. As stated previously even new indicators should be able to be listed under any one of the four areas for all conceivable types of money laundering activity. The visual nature of the model means that at a glance staff can see the risk rating for a particular client and the area in which this risk is highest. This tool is designed as a summary of the risk assessment process, it is not intended to replace the research and in-depth analysis of

the client's accounts. It is a start to determining what questions need to be asked, and where at a glance are the high risks likely to occur within this client's business or account.

The system also helps to categorise risk indicators into more manageable headings and categories rather than having to use one long list with no links to each other. This should assist and speed up the practical reviewing of accounts. The risk assessment model proposed in this research has a number of practical advantages that could be used to speed up risk assessment without losing any quality and effectiveness. Some of these advantages are listed below;

- A. Risk categorisation can focus on more specific areas that need further analysis, rather than having to look at all components at once.
- B. This focused approach makes the workload more manageable.
- C. Completing suspicious activity reports will become more meaningful because risk areas can be described in more detail.
- D. Clients will be clearer which element of their business is holding up clearance for trading finance (e.g. Third party business or country of trading, etc.) so that they can be better prepared next time an application is prepared.
- E. The model is transparent and can be worked on by a number of staff in different units if required.

6.4 Comparing the Risk Assessment Matrix to Industry Reports

This section of the research highlights how the proposed headings for the risk assessment matrix can be used. It takes standard basic red flag indicators for money laundering as suggested by current researchers in this area from AUSTRAC, and reclassifies them into the new model.

6.4.1 AUSTRAC Typology Reports

In each of the different typology and case studies reports produced by the Australian financial intelligence unit AUSTRAC (2011,2013,2014) a number of indicators were identified after each study. It is their standard practice to present the key indicators after providing a scenario or detailed case study, however, for this research project we are interested in the overarching indicators common to many money laundering schemes and especially related to TBML activities. As part of this research project the AUSTRAC indicators from 2014⁸⁵⁰ have been used but re-classified under the same four new indicator headings that were developed in the previous section of this research, to see if the same pattern continues across all the typologies for all financial crime related risks. The results of that process are shown below where they have been classified into four key themes of

⁸⁵⁰ AUSTRAC. (2014). Typologies and case studies report. Australia: AUSTRAC

Geographic Risks, Client Risk, Account Transaction Risks and Third Party Risks.

Reports such as FATF and AUSTRAC tend to list red flags as one long list of indicators specific to each type of money laundering activity. The key difference with this model is that all financial crime risks are analysed using 4 risk headings. This means that regardless of the suspected type of criminal money laundering activity being used, or if a combination of types is used then this matrix can be developed to include everything.

AUSTRAC red flags have been used in this example because they are derived and sourced from real live investigation cases that have been analysed and then sanitised. This gives a section of indicators that cover a wide variety of money laundering techniques, all of which are based on actual ML scenarios. They are normally presented after each specific case to help banks identify potential risk areas and the type of money laundering activity that may be being used, however in this example they have been used as generic red flags and listed under the four categories of the risk matrix to illustrate how all ML cases can be assessed using these four generic headings.

6.4.2 Geographical/ International Funds ⁸⁵¹

International fund transfer is in itself a full risk factor and every international transaction needs to consider the risks inherent such as;

- A. International funds transfer to a country of interest to authorities /
International funds transfer to high-risk jurisdictions
- B. Structured international funds transfers within a short period of time
- C. Use of overseas bank accounts (suspicious use)
- D. High-volume and high-value incoming international funds transfers
to Australia for no apparent logical reason
- E. Incoming international funds transfers from a high-risk jurisdiction
- F. Multiple international funds transfers, which are inconsistent with
the established customer profile
- G. International funds transfer to overseas businesses similar in total
value to recently received cash deposits
- H. Multiple low-value international value transfers
- I. Cash used to pay for international funds transfers
- J. International funds transfer where an individual is both the ordering
and beneficiary customer
- K. Large cash withdrawals in a high-risk jurisdiction
- L. Use of tax secrecy jurisdictions
- M. Outgoing funds transfers sent to offshore entities followed soon
after by incoming funds transfers of similar amounts from the same
offshore entities

⁸⁵¹ AUSTRAC. (2014). Typologies and case studies report. Australia: AUSTRAC

6.4.3 Client

Client risk has traditionally been part of simple risk assessment matrices for AML, and this should continue although suspicious behaviour and sudden unexpected changes in business practice are of particular note.

- A. Customer unwilling to produce identification when requested by reporting entity staff
- B. Structuring of gaming chip cash outs to avoid reporting obligations / High-value or structured casino chip cash buy-ins
- C. Use of false identification
- D. Conflicting or incomplete identification details provided for different transactions
- E. Customer becomes irate when questioned over financial transactions
- F. Large amount of cash used to place bets at a casino over a short period of time
- G. Refusal to show identification when undertaking cash buy-ins of gaming chips
- H. Customer undertaking complicated transfers without a business rationale

6.4.4 Transaction

Transaction risks were again always part of the basic framework, however the knowledge and understanding of many money laundering schemes has now evolved and this list has become more specialized ⁸⁵².

- A. Multiple low-value international funds transfers
- B. Increase over time in the value of transactions with a digital currency exchange
- C. Structuring of multiple cash deposits below AUD10,000 to avoid reporting obligations
- D. Multiple cash withdrawals below the AUD10,000 reporting threshold (that is, structured cash deposits)
- E. High-value cash deposits at multiple bank branches over a short period of time
- F. Multiple same-day cash withdrawals conducted at ATMs and the same bank branch
- G. Customer undertaking transactions that appear to be inconsistent with their customer profile and transactional history
- H. Large cash withdrawals from multiple bank branches on the same day
- I. High-volume and/or high-value cash withdrawals at multiple bank branches and ATMs
- J. Outgoing international funds transfers to pay out a mortgage
- K. Use of debit cards to purchase high-value goods
- L. Structured financial transactions in personal and business names

⁸⁵² AUSTRAC. (2014). Typologies and case studies report. Australia: AUSTRAC

- M. Sudden increase in financial activity inconsistent with individual's transaction history
- N. Withdrawals conducted quickly after deposits
- O. Unusually large volume of cash deposits and withdrawals
- P. High-volume account activity involving significant amounts of cash funds
- Q. Customer receives international funds transfers described as 'loan'

6.4.5 Business Partners / Third Party involvement⁸⁵³

This is another new area in risk assessment, which is the relationship to other business partners. Many clients can be used as fronts by launderers and some third party business deals may actually be exchanges between multiple companies owned by the same client. This factor also needs to be considered in light of the geographical risks and transactions risks to establish a full picture of the business arrangements.

- A. Multiple customers linked by common addresses, conducting international funds transfers to the same overseas beneficiary
- B. International funds transfer from an individual account to several offshore accounts held in the names of third parties
- C. High-value transfers to accounts held in the name of a casino and gaming venue

⁸⁵³ AUSTRAC. (2014). Typologies and case studies report. Australia: AUSTRAC

- D. Third-party transfers to and from accounts for no apparent logical reason
- E. Multiple domestic transfers to third-party accounts
- F. Structured cash deposits into a bank account from third parties
- G. Third parties making regular cash deposits into a business account
- H. Multiple electronic transfers from third parties
- I. Multiple customers conducting international funds transfers to the same overseas beneficiary
- J. Use of an accountant to facilitate unusually complicated transactions
- K. Use of charitable organisations with a lack of business rationale
- L. Use of third-party company accounts in an attempt to complicate transaction activity
- M. Use of third-party or family member accounts

The difference with this model is that risk assessment is seen within one framework rather than being segregated into lots of different typologies. Using the AUSTRAC or FATF guidelines the banking sector would have to analyse every client using every single money laundering scenario unless there was a clearer way to amalgamate data and undertake an overall analysis of risk.

The case studies that were used in this report covered a range of different money laundering schemes including the use of casinos as well as business transactions and the use of personal accounts or family member accounts. As can be established from this exercise all the

indicators can be classified under one of the four identified headings suggested for TBML. This would imply that all AML risk assessment regardless of the specific technique, can operate from within the same basic risk assessment framework. Although some of the specific indicators may only relate to certain systems and approaches used in money laundering, the principle of looking across four different components of risk is the same. This should facilitate training programmes since the same basic techniques are being reinforced even when new schemes are discovered.

I have held back from offering any critique in the form of intelligent analysis to the Austrac material that has been taken from their reports. The point behind its use was to demonstrate where the criteria fits in with the new model I am proposing and not to assess the effectiveness of Austrac's red flags which are accepted and already in use internationally.

6.5 AML Risk Auditing

The second part of the risk assessment framework is the AML audit component. This is the objective assessment of the efficiency and effectiveness of the risk assessment mechanisms that are being used across all units within the bank. It also produces alongside this an evaluation of the resources being utilised by implementing the AML risk

framework and examines the impact that this investment has had on reducing the banks' risk of exposure to money laundering activity.

6.5.1 Internal Audit

During the interviews and the questionnaire, the respondents were asked about the role of internal audit within AML compliance. Many of the answers assumed that internal audit did not have a role to play, with some responses suggesting that there would not be the skill level within internal audit to be involved at any level *"I don't think it [IA] generally has the skills to be able to deal with the complex risk issues faced here."* (Respondent 1618). However, internal audit has been identified as the third line of defence⁸⁵⁴ therefore it has to develop a role for itself at some level, and the knowledge base does need to be raised in relation to regulatory and compliance requirements. *"Internal auditors collectively must have comprehensive knowledge and a deep understanding of BSA/AML regulations and leading practices."*⁸⁵⁵

⁸⁵⁴ PwC. (2014). Goods gone bad. Addressing money-laundering risk in the trade finance system.

⁸⁵⁵ Ibid.

6.5.2 The role of audit within AML compliance

Despite the widely held view that internal audit does not have a major role in the detection of AML activity within banks, it is understood that it has a role in auditing AML activity. The difficulty is perhaps in identifying the difference between traditional and AML auditing practice, and from that information being able to develop a system that addresses the deficiencies in current AML auditing practice. In order to understand what an AML audit is in more detail the following sections describe the areas that need to be included in the audit, as well as the differences between AML auditing and AML compliance.

6.5.3 AML Auditing (and TBML)

Internal audit is responsible for the auditing of TBML and AML compliance measures within the bank. This means that by default internal auditors need a good understanding of AML compliance and a strong awareness of the current risk assessment models in use. Traditionally internal audit may develop an audit plan that highlights which sections of the bank are due for audit that year, which means that AML compliance is only ever audited in sections across the bank depending on which unit is due for auditing that year. However, since TBML and other complex money laundering schemes are becoming such a strong issue that affect

all units across the bank, then the audit plan will need to change in relation to this particular approach.

A number of issues arose during the interviews including the need to specifically address the problems that TBML activity was causing across the bank. The following implications from TBML activity were noted.

1. **Trade Finance Annual Audit** - Trade Finance units in the bank would initially need to be audited annually and cannot be overlooked or given longer timescales between audits. This is important because trade finance is the hub of where TBML activity will be occurring. Criminal clients and schemes of money laundering will often change considerably during a 12-month period; this is in addition to the unit acquiring new criminal clients.
2. **Front Office Staff** - Similarly work with front staff will need to prioritise auditing trade finance clients and business clients using cross border transactions, as these are most vulnerable to TBML abuse.
3. **Red Flag Review** - A review of red flag indicators and sources of risk assessment research will need to be considered and updated each year, as trade data and AML publications change constantly. A global interest in TBML prosecutions as well as all cases of money laundering across jurisdictions and the methods used will need to be catalogued within the trade finance unit. The relevance

and dates of material needs to be routinely assessed as part of the audit.

4. **KYC information** - The completeness of KYC information including CDD, EDD, PEP and BOI all need to be reviewed annually. This information should be logged and can be audited through an IT programme initially to detect completeness of various fields, followed by manual random inspection. This can be used to check the quality of information and accurateness of the completed documents.
5. **A Review of Suspicious Activity reports** - SARs need to be reviewed and catalogued within the AML unit. There is also a need to record the reason the SAR was initiated and the final outcomes including ongoing monitoring outcomes for each client. This will ensure that lessons gained from each suspicious activity are being fed back into the AML loop of information. These catalogues should also form the basis for internal research conducted through any risk assessment process.
6. **Audit** will also need to consider changes and recommendations produced at an international level through organisations such as FATF as well as other FIU reports.
7. **A national AML compliance strategy** should also ideally be in place, that can then guide best practice for AML audits within each country

Some of these processes can be automated or computerised, However, the real strength of internal audit is the capacity to physically inspect and interview staff involved in the process. This means that genuine concerns and findings can be captured as early as possible and redressed either through training, communication and collaboration with other units or by linking into outside agencies as appropriate. If other mechanisms are required, then these can be developed and recommended as part of the internal audit report to the audit committee which can also be followed up by the external audit team.

6.5.4 Internal Audit or AML Audit

The role of AML audit has been allocated unofficially to the Internal Audit Function (IAF) because it is a structure that is currently in existence. The question at this stage is whether a dedicated AML audit team would be a better option, one which would start with a strong AML knowledge base that could over time gradually incorporate regular internal audit functions into its remit? Although this question extends outside of the remit of this thesis it is an important discussion for banks to have, since major resources will be invested into AML compliance issues over the next five years or so and all options in relation to potential cost benefit effectiveness should be considered at this earlier stage.

6.5.5 Difference between AML Compliance and AML Audit

The remit of the thesis does not extend to fully examining the differences between the two distinct processes of AML compliance and audit. The main difference is that AML compliance is the practical process of carrying out the collection and inspection of KYC information and tracking accounts. This is usually undertaken by all members of the bank at various levels depending on the relationship the client has with the different sectors of the bank and the services being utilised. Whereas it is the role of AML audit to assess the relevance and effectiveness of the risk assessment system being used, a role that is usually undertaken by an objective and separate role within the banking structure such as internal audit. It is also the role of audit to make recommendations to the audit committee and governance on the allocation and relevance of resources, training and staffing allocation to deal appropriately with the AML compliance requirements.

However, in reality, according to some of the research responses internal audit tends to perform a checklist audit that determines whether a risk assessment system is in place.⁸⁵⁶ The effectiveness of the system is not usually considered as part of the audit process beyond ensuring that suspicious reports are generated and sent onto the FIU as part of the regulatory requirement. In other words, most internal audit reports focus on the compliance aspect of AML regulation rather than its effectiveness.

⁸⁵⁶ FATF. (2006). Trade based money laundering. France. Financial Action Task Force

Although the role of internal audit has been identified as needing autonomy and to be distinct and separate from the role of MLROs and other AML or business unit staff, it still currently retains a position as the third line of defence within AML risk assessment. If a role is to be kept for internal audit function within AML compliance and risk assessment, then the skills of auditors need to be specifically tailored to understanding trade and finance money laundering. Therefore, in many cases internal auditors do need their knowledge to be improved if they are to retain a relevant and useful role within the overall AML compliance response.

6.5.6 Data Technology

The use of technology has been suggested by some authors⁸⁵⁷ as a way of assessing some of the risks associated with trade related money laundering schemes. However, using trade data within audit has not really been suggested other than to be noted by some auditing companies that the use of data analytics is not adequate by internal audit.⁸⁵⁸

6.6 Layer Defence Model

⁸⁵⁷ Zdanowicz, J. (2009). Trade Based Money Laundering and Terrorist Financing. Review of Law and Economics Vol 5 No.2, 855-878.

⁸⁵⁸ PwC. (2014). Goods gone bad. Addressing money-laundering risk in the trade finance system.

Traditionally the banking model has operated from a three lines of defence approach to AML risk assessment, which have been designed as a hierarchical system whereby each level is intended to check the level below and ensure it is operating effectively. In this model the first line of defence is supposed to detect actual money laundering activity as it enters the bank by the banking staff across the different units. At the second line of defence there are compliance testing and quality assurance systems that can check that risk assessment systems are happening, whilst at the third line of defence internal audit provides an outside objective check that systems are being adhered to.

Line 1 - Operational, risk management and quality controls

Line 2 - Quality assurance, risk management, validation and compliance testing

Line 3 - Internal audit ⁸⁵⁹

However, one of the fundamental flaws in this design is that it is still possible that inherent weaknesses can undermine all three lines of defence at once. Even if the weaknesses are in different areas within each of the different lines it is very possible, rather like the Swiss cheese model, that the holes or gaps in the system can still be lined up and permit money laundering activity to pass through undetected. Examples of some of these areas of weakness can include the following;

⁸⁵⁹ PwC. (2014). Goods gone bad. Addressing money-laundering risk in the trade finance system. P3

Line 1

- a) Lack of specific knowledge of different money laundering schemes at the operational level.
- b) Lack of communication between different units within the bank regarding concerns about a specific client.
- c) Lack of training provided on the bank's own internal systems for reporting suspicious activity.

Line 2

- a) Quality assurance framework is not linked to national and international standards.
- b) Lack of support from governance meaning that audit reports are not responded to appropriately.
- c) Governance focus is on compliance risks rather than legal or money laundering risks.

Line 3

- a) Internal audits are conducted on a unit by unit basis rather, than undertaking a full AML audit across the bank.
- b) The knowledge of different money laundering schemes in IAF is weak and therefore staff are unable to assess the effectiveness of the bank's AML systems.
- c) Audits are regulatory and compliance led rather than assessing for effectiveness.

6.6.1 A New Model of Risk Assessment

The risk assessment model that is being suggested in this paper has developed a risk framework that has also incorporated the three lines of defence approach. However, this research paper is suggesting that a different use of the three lines of defence should be considered. In this model it comprises four lines of defence since the actual development of a risk framework is another line of defence that has been added.

Line 1 - Risk framework, governance corporate attitude, resources

Line 2 - Operational risk management - risk matrix - all units of the bank

Line 3 - National compliance and international compliance standards, quality assurance

Line 4- AML audit process - link to line 1

In this model there are not hierarchical lines of defence, but instead layers of defence that operate in an integrated model of AML risk assessment. Each layer operates alongside the other layers and they each continue to inform and regulate each other. This reduces the risk of money laundering activity passing through one layer and onto the next undetected, because in this model each layer constantly interacts with each other.

This model reflects the learning that has emerged from the research project under a number of headings and from across both the research data and also findings from empirical studies and case reports. The key learning from these sources has been summarised below;

1. AML Audit is a separate part of the risk assessment process, which currently fits into the role of internal audit function because it also requires an independent and objective assessment.
2. The enhanced role of governance is needed to ensure that appropriate levels of resources are allocated as and when required.
3. The allocation of resources is now determined in line with a strategic plan for risk assessment, rather than individual lobbying by the AML compliance section, or relying on decisions made in isolation by the audit committee.
4. Since countries are assessed by FATF on an individual basis they are therefore able to respond to this feedback through a strategic national plan for addressing deficiencies and weaknesses in money laundering compliance. Both of these international and national standards for AML compliance need to be reflected within individual organisational strategic plans for AML compliance.
5. Operational risk is not a line of defence but it is an ongoing process undertaken by different units within the bank at different times with the same client.

6. Operational risk processes need to be audited in line with international and national standards and also against governance priorities and resource allocation.

6.6.2 National Quality Standards

One of the issues that was not raised at any level within the research and which may need to be considered in the future, is the establishment of national quality standards frameworks for AML compliance within the banking sector.⁸⁶⁰

The FATF have continually produced guidance documents and have issued the 40 recommendations,⁸⁶¹ which are generally viewed as international standards. However, at a national level it could be considered useful to develop a quality standards system that includes linking to the specific law enforcement, financial intelligence units and other agencies that have designated roles as well as the banking and financial services sectors.

The national standards could be more specific and link to the specific legislation as well as named units within external agencies

⁸⁶⁰ This would be a Quality Standards system that specifically looks at training requirements for AML officers and other banking staff, as well as having clear policies and procedures for reporting and identifying AML risk and clear timelines for updating policies and reviewing training needs.

⁸⁶¹ FATF. (2012). International standards on combating money laundering and the financing of terrorism & proliferation [The FATF Recommendations]

including law enforcement. FATF continues to produce national country reports which are used to highlight areas of weakness as well as considering legislative and regulatory issues at a national level, it would therefore appear logical that a national body would be able to implement their own strategic plan for AML compliance through the development of a set of national quality standards.

CHAPTER 7 CONCLUSION

7.1 Introduction

This research project has focused specifically on the impact of trade based money laundering (TBML) within the banking sector and explored possible options for improving the risk assessment processes and detection rate within banks. The research was interested in exploring what systems are currently in place within the banking structure to detect TBML, and where potential gaps might exist within these systems. In particular, two areas of interest have been explored throughout the research;

1. The role of internal audit and changes that may need to be made to develop an effective risk audit response and
2. Risk assessment for TBML activity and the different requirements of trade related laundering techniques compared to standard AML risk assessment processes.

One of the roles of the bank is to try and build an understanding of the client and their business⁸⁶² (so that TBML does not occur using the bank's resources or facilities). In this research the focus was specifically on trade-based money laundering as it applies within the global banking sector. Although the two areas of audit and risk assessment might be considered as separate entities, and as such topics for two different theses, the link was made in this study that TBML and AML risk assessment needs to be

⁸⁶² PwC. (2014). Goods gone bad. Addressing money-laundering risk in the trade finance system.

developed within an overarching framework of a comprehensive AML system. In other words, auditing and risk assessment can no longer be considered as separate and independent functions within the bank, instead they both need to be fulfilling the requirements of a broader AML strategy.

7.2 An AML Risk Assessment Strategy

The primary focus of this research study was to develop a risk assessment framework that was cognizant of the two different but interrelated functions of auditing and assessing risk. The AML framework needed to be useful and relevant to practitioners within the banking sector and at the same time embedded in knowledge from previous studies and academic or theoretical analysis. This was ultimately achieved by considering the opinions and evidence from a wide range of practitioners and academics, all of whom who are currently working in the field of TBML and AML detection, and to amalgamate the findings from these multiple perspectives into one cohesive framework. Alongside this and throughout the research two important elements were continuously reviewed; these were evidence from the empirical data and from staff working in the banking environment and secondly the theoretical and academic perspective on TBML. The model that was finally developed had both a theoretical and an empirical component that could both be supported by the research findings.

7.3 Theoretical Framework

The theoretical framework that has been developed in this project and which is to be applied to money laundering cases, revolves around the principal agent theory or Agency theory.⁸⁶³ In particular, the literature identified that the response of banks to pressure from the AML regulator has been recognised as part of a principal-agency principal theory, whereby the regulator is the principal and the bank acts as the agent.⁸⁶⁴ Although the bank effectively acts as an agent to the regulator it is also noted that in the absence of strict rules and regulations it will not be as diligent in its tasks.⁸⁶⁵ This is partly due to the nature of the bank - client relationships where the bank also acts as an agent to the client and there is therefore an inevitable conflict in roles when regulation starts to interfere with client's business.

One data study source that was used in the research was the HSBC case in Switzerland.⁸⁶⁶ In the Swiss bank case the agency theory model has also been applied beyond banking/client principal-agent

⁸⁶³ Eisenhardt, M. (1989). Agency theory: An assessment and review. *Academy of Management. The Academy of Management Review*, 14(1), 57-74.

⁸⁶⁴ Pellegrina, L. D., & Masciandaro, D. (2008). The Risk Based Approach in the new European Anti-Money Laundering Legislation: A Law and Economics View. "Paolo Baffi" Centre Research Paper Series No. 2008-22, 1-24.

⁸⁶⁵ Macey, J. (1991) "Agency Theory and the Criminal Liability of Corporations." *Faculty Scholarship Series. Paper 1716*: 315-340. http://digitalcommons.law.yale.edu/fss_papers/1716.

⁸⁶⁶ ICIJ (2015) Swiss leaks: Murky cash sheltered by bank secrecy <http://www.icij.org/project/swiss-leaks/banking-giant-hsbc-sheltered-murky-cash-linked-dictators-and-arms-dealers> accessed 2 March 2015

relationships, to consider the relationships between banks and regulators and in particular the outside constraints imposed on banks through international regulation and legal challenges.⁸⁶⁷ This was noted through the impact of tax evasion of other economies outside of Switzerland, due to the actions of the HSBC bank. The role of international media and whistle blowing is potentially an extension of this theoretical framework, and provides yet another source of pressure on banking behaviour, i.e. internal pressure from staff or ethical conflict between some members of management and/or staff within the bank.

A similar situation was witnessed in the Credit Agricole case⁸⁶⁸ whereby an external client took legal action against the bank for failing to implement effective due diligence processes and failing to file a suspicious activity report.⁸⁶⁹ The bank claimed that CDD and suspicious alert systems were not as advanced in 2000 and that this situation would not have occurred in the current context.⁸⁷⁰ However, other investigative reports such as the ICIJ⁸⁷¹ and also industry research reviews such as PwC⁸⁷²

⁸⁶⁷ Pellegrina, L. D., & Masciandaro, D. (2008). The Risk Based Approach in the new European Anti-Money Laundering Legislation: A Law and Economics View. "Paolo Baffi" Centre Research Paper Series No. 2008-22, 1-24.

⁸⁶⁸ Privy Council Appeal (2015) Judgement Crédit Agricole Corporation and Investment Bank (appellant) v Papadimitriou (Respondent) (Gibraltar) UKPC 13 Privy Council Appeal No 0023 of 2014 https://www.jcpc.uk/decided-cases/docs/JCPC_2014_0023_Judgment.pdf accessed 15 May 2015

⁸⁶⁹ Croft, J & Chassaney, A-M (2015) Crédit Agricole loses suspicious transaction case <http://www.ft.com/cms/s/0/ef67acea-e9b4-11e4-b863-00144feab7de.html#axzz3Zd0pvgKH> accessed 9th May 2015

⁸⁷⁰ Croft & Chasney (2015)

⁸⁷¹ ICIJ (2015) Swiss leaks: Murky cash sheltered by bank secrecy <http://www.icij.org/project/swiss-leaks/banking-giant-hsbc-sheltered-murky-cash-linked-dictators-and-arms-dealers> accessed 2 March 2015

⁸⁷² PwC. (2014). Goods gone bad. Addressing money-laundering risk in the trade finance system London, PriceWaterhouseCoopers

and KPMG ⁸⁷³ all highlight that many systems are operating the same today as they were back in 2000 since there has been little up skilling or training available to adequately inform banking staff of the increased risks.

When the defence team stated that the bank did not know that the money was being used for illicit purposes, the prosecution asked that the Judge consider the outcome of another banking case, Sinclair Investments (UK) Ltd. v Versailles Trade Finance Ltd [2011] 4 All ER 335 ⁸⁷⁴ in which Lord Neuberger declared that the case would assess what the banks should be expected to know or should have known, given their experience and professional knowledge. The judge in the Credit Agricole finally decided that the bank should have known from the nature of the transactions that this was a fraudulent business.

Instead in this situation regulatory pressure has been reinforced through a legal ruling which in a theoretical context means the legal system has increased the strength of the principal. The bank as an agent, now has less flexibility in choosing how or whether to implement and check AML compliance systems. The case was also an illustration to regulators that others may step in and also challenge their work, since this case should perhaps have been flagged through the national regulator rather than taken as an independent legal challenge by a third party client.

⁸⁷³KPMG (2014) Global anti-money laundering survey. London

⁸⁷⁴Gibraltar Court Services (2013) Irene Michailidis v Credit Agricole Corporate and Investment Bank http://www.gcs.gov.gi/images/judgments/supremecourt/2013/irene_michailidis_v_credit_agricole_corporate_and_investment_bank.pdf accessed 15th May 2015

The final legal case that was discussed was the HBUS case in the US. In this situation AML compliance was not being treated as a priority and the regulator was forced to intervene and raise concerns.⁸⁷⁵ Although this places pressure on the banks most cases taken by regulators result in affecting the banks reputational risk through negative media coverage and having to pay a fine, rather than any criminal charges being taken against the bank or its employees. The lack of criminal liability or gross negligence cases means that banks can still consider AML compliance purely as a cost centre rather than a legal obligation. The risk of losing clients on one side of the agency dilemma versus increased pay-outs in fines is the current situation that banks are having to negotiate with, and this can be a fine line to tread financially, given the ever increasing costs of implementing AML compliance. This means that in effect a large amount of change is dependent on the overall corporate attitude of the bank and whether it chooses to prioritise AML risk assessment rather than being compelled to do it through increased regulatory pressure. This latter point under the agency model, would need to be increased quite considerably before it had any major productive impact on international money laundering given the current response rate. In other words, not enough change is occurring in the banking system because there is not a clear international requirement to do so.

⁸⁷⁵ Homeland Security. (2012). HSBC exposed US financial system to money laundering, drug, terrorist financing risks. From permanent sub committee on investigations. US Senate. Retrieved from <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/us-vulnerabilities-to-money-laundering-drugs-and-terrorist-financing-hsbc-case-history> accessed 4 August 2015

7.3.1 Influences on the Agent - Corporate Attitude

Alternatively, if other influences on the agent from internal sources changed, then this would also influence the agent principal relationship. If for example the corporate attitude of the bank changed and re-prioritised AML risk assessment then a shift in attitude, training and resources would also occur. Internal pressure could come from whistle-blowers and outside clients, who were sources in two of the cases used in this research that highlighted ineffective practices occurring within the banking structure. However, very few staff members might be willing to jeopardize their future careers especially if banks made it clear that this practice would not be tolerated. A stronger culture of secrecy could encourage a more entrenched and defensive approach to compliance rather than opening the dialogue and moving it beyond the realm of the banking sector.

The media has become a strong influence on the banking culture since it has started chasing criminals and organisations and tracking their financial flows. Different organisations such as Global Financial Integrity⁸⁷⁶ have been tracking and raising awareness of how corruption and other related crimes can cause illicit flows from developing economies into developed economies and the impact that this is having on international development. The international consortium of investigative journalists⁸⁷⁷

⁸⁷⁶ Kar, D., & LeBlanc, B. (2013). Illicit financial flows from developing countries 2002-2011

⁸⁷⁷ ICIJ (2015) Swiss leaks: Murky cash sheltered by bank secrecy <http://www.icij.org/project/swiss-leaks/banking-giant-hsbc-sheltered-murky-cash-linked-dictators-and-arms-dealers> accessed 2 March 2015

have highlighted how they are willing to work alongside governments with data acquired from whistle-blowers. The United States investigative departments such as the FBI and International Customs (ICE) have started to take cases through the courts that have begun to identify how banks are inadvertently facilitating illicit financial flows, so that banks are being named in public court documents, which leaves them vulnerable to further follow on investigations.

All of these factors place additional pressure on the corporate governance structures within banks and can influence how management and audit committees decide to prioritise their AML responsibilities. The increase in media coverage across the globe has also affected the information that stakeholders and clients of the bank can obtain about the bank and the expectations that they have for the way in which the bank operates.

7.3.2 Implications Arising From the Theoretical Discussions

The theoretical discussion so far has highlighted two main factors - firstly that there is a limit to what regulation can achieve. In fact, increasing regulation in isolation will encourage more defensive reporting⁸⁷⁸ leading

⁸⁷⁸ Takáts, E. (2007). A theory of "crying wolf": The economics of money laundering enforcement. Ana Lucia Corofnel. IMF Working Paper

to the risk that AML reporting and risk assessment will become compliance led rather than risk based. The second point is that international media pressure and highlighting the link between different financial crimes, can perhaps encourage banks to develop a more holistic approach to financial crime generally. This might be more productive rather than perceiving money laundering compliance as a separate and costly activity that is only being implemented for someone else's benefit i.e. the regulators and state bodies such as law enforcement.

There are also other theoretical frameworks that could be applied at this juncture since it also fits into the rational decision making model, whereby governance structures are facing a multitude of decisions and respond to wherever they feel the greatest pressure is coming from. In this model rationale decision making theory becomes one influencing factor within the Agency model. However, one fact that has emerged from both the rationale decision making and agency theories is the following; since the AML decisions will continue to present as situations requiring resources and prioritisation, then the influences towards implementing a risk based approach towards money laundering and financial crime need to become stronger and more forceful in order to be heard. In other words, the louder voice will be heard but regulation by itself probably is not loud enough.

7.3.3 Broader Application of Theoretical Analysis

There are a number of practical implications to using a risk based framework, some of these benefits can be seen by considering some of the legal and media studies used in the research. For example, if an overarching AML framework had been present in the HBUS case instead of an isolated AML compliance unit, then trying to lobby for resources and raise awareness of the difficulties it was facing might have been more successful. In that situation the large backlog of 17,000 suspicious alerts⁸⁷⁹ would have been seen as a failure to adequately implement the AML compliance framework, which should have been flagged internally by all the pillars of governance (audit committee, internal audit, governance and external audit) and viewed as a high priority. Instead the alerts were viewed as an administrative error or mismanagement of staff time, and this was then designated as a low priority for the bank's governance and audit review.

To apply this to the agency dilemma model the pressure on governance was weak and unsupported, therefore it wasn't being flagged within the system and demanding a response. The needs of the clients to conduct business and the need of the bank to ensure that the business of the bank continued to operate, were viewed as more important issues. This corporate attitude of prioritisation was not changed until the regulator

⁸⁷⁹ Homeland Security. (2012). HSBC exposed US financial system to money laundering, drug, terrorist financing risks. From permanent sub committee on investigations. US Senate. Retrieved from <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/us-vulnerabilities-to-money-laundering-drugs-and-terrorist-financing-hsbc-case-history> accessed 4 August 2015

finally reported the problems, thus placing greater pressure onto the agent to change behaviour.

The final question in relation to the theoretical context of the framework is to determine whether the other financial crime activities would fit into this model as well or is it only specifically for money laundering. In the HBUS case one of the issues was bulk cash smuggling through correspondent accounts, which is still a large concern and is being used by criminal organisations despite international AML requirements.⁸⁸⁰ However, bulk cash deposits along with the bulk travellers' cheques are both issues that can be highlighted through a more stringent internal risk assessment framework. Research on the countries involved in the transfers would have flagged drug smuggling and a high risk of cash deposits; this should have informed the categorisation of risk. Following on from this categorisation and independent of whether the risk assessment process was implemented at a staff level, the internal audit should have outlined all the risks the bank was exposing itself and other services to by facilitating these transactions, this information should have been presented to the audit committee. Finally, if the governance structure had developed a corporate attitude that supported decisions and information provided from the audit committee and equally supported a culture, which refused to engage in potential criminal activities, then the governance structures within HBUS would have heard the concerns earlier and prioritised resources to address the issue.

⁸⁸⁰ FinCEN (2015) FinCEN Targets Money Laundering Infrastructure with Geographic Targeting Order in Miami http://www.fincen.gov/news_room/nr/html/20150421.html accessed 12 August 2015

One of the weaknesses in the HBUS case was that the governance structure operated in a climate of knowledge deficiency, even the information from one of the regulatory bodies was seen as misleading and may have been an attributing factor in the slow response to address the problems at a management level.⁸⁸¹ Although this reflects the agency model it also fits into the rational decision making model, whereby governance structures are facing a multitude of decisions and respond to wherever they feel the greatest pressure is coming from. However, rational decisions can only be made if the appropriate level of information is available. For this reason, even regulatory advice needs to work alongside other factors such as the bank's risk based approach that seeks to determine the risk classification of clients and countries. All the information needs to be analysed within a stronger internal risk framework, one that is supported by independent research rather than relying on a correspondent bank name or a named individual. This risk framework based system helps to ensure that decisions on risk status are transparent and consistent, based on research from multiple sources including checks with other banks.

7.3.4 Summary of Theoretical Analysis

⁸⁸¹ Homeland Security. (2012). HSBC exposed US financial system to money laundering, drug, terrorist financing risks. From permanent sub committee on investigations. US Senate. Retrieved from <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/us-vulnerabilities-to-money-laundering-drugs-and-terrorist-financing-hsbc-case-history> accessed 4 August 2015

The theoretical framework was used in this study to help understand how and why banking decisions regarding AML compliance have been made, and how they are likely to be made in the future. Without this contextual understanding it becomes harder to develop a risk assessment framework that can work.

One future role of a risk assessment model could be used by the bank to determine whether the use of resources needed for AML compliance was effective, since it would highlight where gaps in the system existed and which areas needed resource inputs. The same AML risk framework would also guide the audit committee so that they would have a clearer framework from which to operate, and it would ensure that their agenda on AML compliance was not in conflict with governance over the same issues. The overall process of AML decision making would become part of the AML risk framework, as opposed to the current situation in many banks where individual activities are being carried out in isolation, such as identifying the risk alerts and assessing trade finance risks, where budget allocation is assessed as an administrative add on.

7.4 Research Proposals

The research survey and interviews highlighted a number of areas of development that banking AML risk assessment perhaps needs to consider in the future. As a result of this research analysis the following

suggestions have been made as a way to further strengthen current banking approaches to AML and TBML risk assessment planning.

7.4.1 New Empirical Risk Assessment Framework

It was always planned that the risk framework that was finally developed would be used or piloted within the banking sector at a later stage, therefore it needed to be practical and realistic. The final design that has been proposed was based on a model that was already familiar to most banking institutions, that of a risk matrix. Many banking institutions currently use various adaptations of a simple risk matrix model however, this particular matrix can be applied with varying degrees of complexity, depending on the resources of the institution seeking to utilise it.

The research has produced a new format for risk assessment that also provides a model for analysing and using individual money laundering red flags, from any scenario.

7.4.2 Four Areas of Risk (as opposed to the traditional two)

In its basic format there are four key areas of money laundering risk that have been identified in this research, which are; the

1. Client behavioural risk,
2. Transaction risk,
3. Geographic risk and
4. Third party risk.

Together these four headings have been shown to cover all the major red flag alerts connected with TBML schemes and other money laundering techniques as identified by prior reports and research in this area. The use of the four headings, it is hoped will encourage a holistic analysis of the client's account and business. Another advantage of this simpler design was that even if it was only applied as a tick box checklist, it would still ensure that four different categories of risk would be considered. This is still an advancement on the traditional risk assessment model whereby only client and transaction patterns were considered, and red flag alerts were listed as one long group without any differentiation.

Alternatively, the risk model could be used as a resource to facilitate other more complex risk assessment techniques, such as a means to categorise indicators and to apply these categories into their IT solutions for AML, or other computerised software. However, despite the level of complexity of the individual banking risk assessment approach for TBML, all risk assessment systems in the future will need to reflect the increased complexity that criminal organisations are now using in order to access the formal financial services. In particular banks need to look beyond the basic standard large scale cash deposits and suspicious unknown clients. Many money laundering schemes have developed in sophistication and are now using complex international wire transfers as well as using existing and well established clients within the bank, as front businesses for their money laundering activity.

7.4.3 Implications of Needing TBML Knowledge

The biggest challenge for both the banking institutions and the regulatory agencies when undertaking TBML detection, is the amount of specialised knowledge that is needed on trading and shipping finance. The knowledge that is required extends beyond the financial element to include an understanding of international shipping routes, the use of free trade zones and the use of forged invoices for both the importation and exportation of goods. Typology studies provide some level of insight into schemes that have been used, but more often banks are having to uncover variations of these schemes for themselves. In order to protect the bank a deeper level of understanding is required about the nature of the client's business including knowledge of the nature of the goods being used and the third party business clients that are the other part of the transaction. All of this data needs to be researched and analysed which is both time consuming and costly, and yet as legal cases are beginning to illustrate failure to do so can result in the liability resting with the bank, for failure to carry out their suspicious activity compliance requirements.

There is a need to develop stronger links with FIUs and other organisations that have created databases of information relevant to AML research. This includes the investigative journalist groups (ICIJ) beneficial ownership and off shore accounts database, trade databases as well as government registers of beneficial ownership.

7.4.4 Governance and AML Risk Assessment

The research project developed an overall risk assessment model of which the risk matrix was one aspect. The other layers of AML defence included audit and governance involvement. The TBML risk framework introduced the concept of a specific role for governance and the need to develop a strategic AML plan for the business or bank as a whole, one that could be implemented by all units within the bank. One of the advantages of a strategic plan is that ensures that all aspects of AML compliance, including resources and auditing, as well as setting targets of achievement, are unified across the bank. The difficulty in having a specific unit within the bank, which is called AML compliance, tends to encourage an attitude of assuming others are taking responsibility. This then works against the concept of a holistic approach, whereby AML compliance is seen as an issue to be tackled across the entire bank. The proposed model of a risk assessment framework also challenged the existing model of AML protection used within banking, namely the three lines of defence model.

7.4.5 A New Layer of Defence Model for Risk Assessment

This model uses the traditional areas of operational risk, quality assurance and internal audit as the three main mechanisms by which money laundering risk is reduced. In the new model proposed by the

research findings though a four mechanism model is suggested, one that interlinks each of the four components of; governance, operational risk, quality assurance and audit. The increased role for governance and also the clearer distinction between AML risk assessment and AML audit are both new elements within the banking context for many financial services.

7.4.6 AML Audit

As part of the proposed increase in responsibility within the banking governance structure, the risk framework separated AML audit from AML risk assessment and defined a clear role for both units within the bank. Internal audit function was still considered to be the natural home for AML audits, but there was the stipulation that skill levels and expertise needed to be raised within the internal audit units. There was a noted knowledge gap between what internal auditors were expected to know and what many respondents and empirical reports suggested that they actually knew on the topic.

AML audits have been suggested as a system for informing governance of the progress in eliminating risk of exposure from money laundering activity. AML audits will differ from standard auditing procedures by becoming more focused on assessing the effectiveness of risk assessment processes, rather than assuring governance that a system is in place. The increased responsibility that governance is now facing through legal challenges, means that they now need to be able to

defend the AML system in place and to illustrate how they know that it is the most effective system for their bank. This means that both external and internal audits need to report on levels and relevance of AML training that is undertaken in the organisation. They also need to analyse how research is incorporated into risk assessment systems and to examine the communication and feedback systems within the bank that deal with producing the suspicious activity reports. Finally, AML audits also need to be aware of how reports are deemed suitable to be filed with the financial intelligence unit and what follow on activity occurs once they have been filed.

Finally, the governance influence on the bank's performance can be seen from the impact of corporate attitude and banking response behaviours. This was highlighted as an issue in several of the legal cases and this research compared banking responses to the model used by Cornish and Clarke in their equation for determining behaviour outcomes. Therefore, there needs to be active leadership towards AML responses from the top management positions, otherwise the actual corporate attitude of the bank will prevail and policies will be undermined.

7.5 Empirical Research Material

One of the key aspects of AML research is the need to access relevant material to support CDD and EDD checks as well as beneficial

ownership information. TBML data is potentially huge and as well as training, the relevant banking staff need access to databases that hold much of this information.

The research developed the risk assessment model using a combination of data sources, it was able to access its own data from interviews and questionnaires, but alongside this there were also a number of high profile legal cases. These cases provided a useful data source for analysis and could be used to determine weaknesses within the current AML regime of many of the larger global banks. Although the dates of information in the cases largely pertained to the early 2000 - 2010 there was some evidence to suggest that changes have only minimally occurred since these situations were uncovered. The legal cases also provided an important insight into the banking culture, an issue which is largely kept confidential and difficult for researchers to access. Typology studies are another way in which sensitive cases can be analysed. However, these reports provide examples of situations that have already been detected, often through the banking sector and they do not really give an insight into weaknesses within the system or highlight the types of cases that are currently not being detected.

The issue of TBML is still a relatively new topic even with the institutions that are most exposed to the risks, and as such many experts and practitioners within the field are still grappling to understand the different aspects of this practice and the wider implications for the global

banking sector. This means that even the data received from practitioners is still in an embryo state and many of the opinions shared by the experts are based on limited experience. This presented a number of challenges to the research which is why a theoretical model and the analysis of legal cases was also included as a means to triangulate the findings and seek a common message. Ultimately by combining all the sources together a general pattern of issues and challenges did emerge and from this a proposed model of a risk framework was developed.

At this stage a proposed model of risk assessment has been produced which captures the key points raised by a number of experts within the field. The next stage for a research project on this topic could be to pilot the model within a number of financial institutions and to gain feedback from practitioners and management within the sector on the feasibility and difficulties that such an approach might create. The research is also open to further academic debate since a number of papers have been developed from this work, which can hopefully start to contribute to the discussion of TBML risk at a different level. These papers have explored some of the issues raised in this document in more detail, such as analysing the different legal challenges connected to breaches in money laundering compliance and the implications to the global banking sector from each. Other topics also included the compliance implications for banks, of being involved in facilitating illicit financial flows due to the nature of the funds managed by clients that are actually the proceeds of corruption and bribery related crimes. These topics all explore the

exposure that banks face when not pursuing beneficial ownership information and/or researching the source of client's funds, especially when they are politically exposed persons, including from large commercial companies.

7.6 Concluding statement

Different forms of financial crime, including the laundering of money through trade related activities, continue to present as challenges to the global banking sector. The banks traditional approach of making a distinction between the source of the funds and the money in the client's account is now facing stronger scrutiny by regulators and legislators across the globe. A number of factors are beginning to influence changes in how money laundering risk is being perceived by the financial services sector and by those who are stakeholders and customers of these services. These influences include increased awareness of the use of different methods of laundering including the use of the international trade sector. In response new proposals for increased regulation are being suggested and introduced in different countries, possibly influenced to some extent by heightened media awareness of weaknesses identified within the AML systems of many banks. In essence the global criminal laundering landscape is changing and the banking response to detecting money laundering activity has to change with it, or risk being perceived as part of the problem.

This research aimed to contribute to the discussion and also to increase the level of awareness at both an academic and an empirical level on the topic of money laundering and financial crime. It has focused specifically on the complexities of trade based money laundering as a potential scheme that is increasingly being used amongst criminal organisations across the globe. It has also linked TBML and money laundering activity so that banks can use a more holistic model of risk assessment to support their work. This report has summarised the findings of the research in the form of a practical but new and innovative risk model that has taken the traditional red flags identified by FATF and other guidelines and has produced a practical system for being able to use that data with real clients. In addition, the research has also suggested to academic's further areas for potential future research in this area.

7.6.1 Reflective Statement

This research study was unique in that it focused exclusively on one type of a money laundering scheme: Trade Based Money Laundering. This type of laundering is relatively new and fairly complex to understand, and so the research study raised a number of issues that would be pertinent to banking risk assessment and AML schemes.

1. AML risk assessment systems needed to become more robust and flexible in their approach, rather than seeking to track ML schemes in isolation and independently of one another.
2. Money laundering is a global crime and so information and data sharing systems were needed that could be used across different jurisdictions and agencies.
3. TBML is a complex form of laundering and is broader than just misinvoicing or tax evasion schemes. It involves purchases, shipments and the international transfer of value. In order to be properly detected it requires the co-operation of customs agents and financial services.

The research study has highlighted the potential for a high prevalence of TBML schemes being administered through the financial services sector. During the research it has also been discovered that TBML works alongside other ML schemes and many criminal launderers will mix methods according to whatever barriers are in place.

This has implications for how risk assessment schemes are being set up and maintained, including the need to share and exchange information across organizations. It has also shown how improvements are needed in internal communication systems amongst different units within individual banks, e.g. between front office, trade finance and AML in particular.

The research worked from a theoretical framework that examined the agency relationships between the regulators and the banks and the banks and their clients. This provided an academic argument as to why increased regulation can potentially lead to increases in the complexity of money laundering schemes being used. Therefore, any regulatory changes need to be developed alongside enhanced risk assessment training and risk system development, otherwise smaller banks and institutions could become the target for launderers if they are deemed to have weaker AML systems in place.

Future research is needed on AML risk assessment systems to provide more detail of why gaps in the system emerge. There are three key areas of research that could be pursued which are;

- Monitoring and refining the implementation of a four point risk assessment matrix (such as the one suggested in this project). A case study approach would enable a more detailed understanding of how risk assessment is actually being used within specific banks.
- Working with a wide number of banks to monitor how the risk matrix model is used across different jurisdictions. This research could analyse feedback from across several financial services located in a number of different countries.
- Working in a specific region in order to identify localized patterns of TBML and links to other ML schemes.

It is hoped that this thesis can offer new insights into money laundering, especially TBML and the risk assessment challenges that go with them. The study should be of benefit to the financial industry including banks, regulators and other financial providers.

One of the major changes that the financial services has to address is identifying the source of a client's money, which has become a more important element of AML assessments. TBML is often used as a method in illicit financial flow activities, where money has been sourced through crimes such as bribery and corruption and is being moved out of a developing country's economy into another one.

This means that risk assessment systems need to be able to assess both the source and destination sources of funds. This in turn puts added pressure on criminals to disguise how the money is being moved. It is because of this that TBML will remain a popular choice since trade and shipments add an additional layer in which to hide such transfers and enable money to be easily moved from one country to another.

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